TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS, AND OF CERTAIN DISTRIBUTIONS OF APPRECIATED PROPERTY, AND JOB TRAINING CREDIT PROPOSAL

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

JULY 15, 1982

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TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS, AND OF CERTAIN DISTRIBUTIONS OF APPRECIATED PROPERTY, AND JOB TRAINING CREDIT PROPOSAL

WEDNESDAY, JULY 15, 1982

U.S. Senate,
Committee on Finance,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m. in room 2221 Dirksen Senate Office Building, Hon. John C. Danforth presiding.

Present: Senators Dole [chairman of the committee], Danforth, Chafee, Long, Byrd, and Bradley.

Also present: Senators Metzenbaum and Specter.

[The committee press releases, the bills S. 2224, S. 2547, S. 2687, the description of the bills by the Joint Committee on Taxation, and the prepared statement of Senator Danforth follow:]

Press Release No. 82-144 (rev)

PRESS RELEASE

FOR IMMEDIATE RELEASE
July 8, 1982

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 Dirksen Senate
Office Building

FINANCE COMMITTEE HEARING ON THE TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS

Senator Bob Dole, Chairman of the Senate Committee on Finance, announced today that the Committee hearing on Thursday, July 15, 1982, will consider testimony on S. 2687, not S. 2689 as previously announced in Press Release number 82-144. S. 2687, introduced by Senator John C. Danforth, would change the tax treatment of partial liquidations and of certain distributions of appreciated property.

In addition, Senator Dole announced that the hearing would include consideration of S. 2547, introduced by Senator Howard M. Metzenbaum. S. 2547 also would provide rules concerning tax treatment of partial liquidations and distributions of appreciated property.

A provision similar to S. 2687 and S. 2547 was included in the bill ordered reported by the Finance Committee at an executive session July 1 and 2. Requests to testify will be accepted until noon, Monday, July 12, 1982.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

Press Release No. 82-145
Revised

PRESS RELEASE

FOR IMMEDIATE RELEASE
July 7, 1982

UNITED STATES SENATE
COMMITTEE ON FINANCE
2227 Dirksen Senate Office Bldg.

FINANCE COMMITTEE RESCHEDULES REVIEW OF JOBS TRAINING CREDIT PROPOSAL

Senator Bob Dole, Chairman of the Senate Committee of Finance, announced today that the Committee would receive testimony on S. 2224 on July 15, 1982, rather than July 16 as announced last week. S. 2224 was introduced by Senator Arlen Specter (R.-Pa.) to provide a tax credit for contributions to charitable organizations that provide job training for handicapped and economically disadvantaged individuals and displaced workers. The bill is now scheduled to be reviewed by the Committee in connection with its hearing on S. 2689, "The Corporate Takeover Tax Act," introduced by Senator Danforth. (Press Release No. 82-144, July 2, 1982.)

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

II

97TH CONGRESS
2D SESSION

S. 2224

To amend the Internal Revenue Code of 1954 to allow a credit against tax for contributions to programs providing job training for certain individuals.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, FEBRUARY 22), 1982

Mr. SPECTER introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to allow a credit against tax for contributions to programs providing job training for certain individuals.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code of 1954 (relating to credits allowable against tax) is amended by inserting after section 44G the following new section:

"SEC. 44H. CHARITABLE CONTRIBUTIONS TO QUALIFIED JOB-TRAINING ORGANIZATIONS.

"(a) GENERAL RULE.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 20 percent of the qualified job-training charitable contributions of the taxpayer for the taxable year.

"(b) LIMITATIONS.—

"(1) MAXIMUM DOLLAR AMOUNT.—The amount of the credit allowed under subsection (a) with respect to any taxpayer shall not exceed $250,000.

"(2) LIABILITY FOR TAX.—

"(A) IN GENERAL.—The credit allowed by subsection (a) for any taxable year shall not exceed an amount equal to the tax imposed by this chapter for the taxable year, reduced by the sum of the credits allowed under a section of this subpart having a lower number designation than this section, other than credits allowable by sections 31, 39, and 43. For purposes of the preceding sentence, the term 'tax imposed by this chapter' shall not include any tax treated as not imposed by this chapter under the last sentence of section 53(a).

"(B) CARRYBACK AND CARRYOVER OF UNUSED CREDIT.—

"(i) ALLOWANCE OF CREDIT.—If the amount of the credit determined under this section for any taxable year exceeds the limitation provided under subparagraph (A) for such taxable year (hereinafter in this paragraph referred to as the 'unused credit year'), such excess shall be—

"(I) a job-training credit carryback to each of the 3 taxable years preceding the unused credit year, and

"(II) a job-training credit carryover to each of the 15 taxable years following the unused credit year,

and shall be added to the amount allowable as a credit by this section for such years. If any portion of such excess is a carryback to a taxable year ending before January 1, 1982, this section shall be deemed to have been in effect for such taxable year for purposes of allowing such carryback as a credit under this section. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 18 taxable years to which (by reason of subclauses (I) and (II)) such credit may be carried, and then to each of the other taxable years to the extent that, because of the limitation contained in clause (ii), such unused credit may not be added for a prior taxable year to which such unused credit may be carried.

"(ii) LIMITATION.—The amount of the unused credit which may be added under clause (i) for any preceding or succeeding taxable year shall not exceed the amount by which the limitation provided under subparagraph (A) for such taxable year exceeds the sum of—

"(I) the credit allowable under this section for such taxable year, and

"(II) the amounts which, by reason of this paragraph, are added to the amount allowable for such taxable year and which are attributable to taxable years preceding the unused credit year.

"(c) DEFINITIONS.—For purposes of this section—

"(1) QUALIFIED JOB-TRAINING CHARITABLE CONTRIBUTIONS.—The term 'qualified job-training charitable contributions' means an amount equal to the amount of charitable contributions to qualified job-training organizations.

"(2) CHARITABLE CONTRIBUTION.—The term 'charitable contribution' has the meaning given to such term by subsection (c) of section 170.

"(3) QUALIFIED JOB-TRAINING ORGANIZATION.—The term 'qualified job-training organization' means an organization which—

"(A) is described in section 501(c)(3); and

"(B) has been certified by the appropriate regional office of Employment and Training Administration of the Department of Labor as providing job training solely to one or more of the following: handicapped individuals, economically disadvantaged individuals, and displaced workers.

"(4) JOB TRAINING.—The term 'job training' means instruction in vocational and other skills necessary to obtain employment or a higher grade of employment.

"(5) HANDICAPPED INDIVIDUAL.—The term 'handicapped individual' means any individual who—

"(A) has a physical or mental disability which for such individual constitutes or results in a substantial handicap to employment; and

"(B) can reasonably be expected to obtain employment or a higher grade of employment as a result of job training.

"(6) ECONOMICALLY DISADVANTAGED INDIVIDUAL.—The term 'economically disadvantaged individual' means any individual who—

"(A) receives cash welfare payments under a Federal, State, or local welfare program;

"(B) has an income, for the 6-month period before applying for job training with a qualified job-training organization, which—

"(i) would have met the qualifications for such welfare payments, or

"(ii) if computed on an annual basis, would not exceed the poverty level established by the Director of the Office of Management and Budget pursuant to section 673(2) of the Omnibus Budget Reconciliation Act of 1981; or

"(C) is a member of a family which meets the requirements of subparagraph (A) or (B).

"(7) DISPLACED WORKER.—The term 'displaced worker' means any individual who—

"(A) was employed by an establishment—

"(i) on a full-time basis, and

"(ii) for at least 1 year;

"(B) was not employed by such establishment in an executive, administrative, or professional capacity (as such terms are defined by the Secretary of Labor under section 13(a)(1) of the Fair Labor Standards Act of 1938); and

"(C) is currently unemployed because of—

"(i) a change in the technology of such establishment, or

"(ii) a total or partial closing of such establishment by reason of competing technology.

"(8) ESTABLISHMENT.—The term 'establishment' means any factory, plant, facility, or concern engaged in the production of goods or services, or both.

"(d) SPECIAL RULES.—For purposes of this section—

"(1) AGGREGATION OF CONTRIBUTIONS.—

"(A) CONTROLLED GROUP OF CORPORATIONS.—In determining the amount of the credit under this section—

"(i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and

"(ii) the credit (if any) allowable by this section to each such member shall be its proportionate share of the qualified job-training charitable contributions giving rise to the credit.

"(B) COMMON CONTROL.—Under regulations prescribed by the Secretary, in determining the amount of credit under this section—

"(i) all trades or businesses (whether or not incorporated) which are under common control shall be treated as a single taxpayer, and

"(ii) the credit (if any) allowable by this section to each such trade or business shall be its proportionate share of the qualified job-training charitable contributions giving rise to the credit.

The regulations prescribed under this subparagraph shall be based on principles similar to the principles which apply in the case of subparagraph (A).

"(2) ALLOCATIONS.—

"(A) PASSTHROUGH IN THE CASE OF SUBCHAPTER S CORPORATIONS, ETC.—Under regulations prescribed by the Secretary, rules similar to the rules of subsections (d) and (e) of section 52 shall apply.

"(B) ALLOCATION IN THE CASE OF PARTNERSHIPS.—In the case of partnerships, the credit shall be allocated among partners under regulations prescribed by the Secretary.".

(b)(1) Subparagraph (A) of section 55(c)(4) of the Internal Revenue Code of 1954 (relating to credits) is amended by inserting "44H(b)(2)(A)," before "53(b)".

(2) Subsection (c) of section 381 of such Code (relating to items of the distributor or transferor corporation) is amended by adding at the end thereof the following new paragraph:

"(30) CREDIT UNDER SECTION 44H.—The acquiring corporation shall take into account (to the extent proper to carry out the purposes of this section and section 44H, and under such regulations as may be prescribed by the Secretary) the items required to be taken into account for purposes of section 44H in respect of the distributor or transferor corporation.".

(3)(A) Section 383 of such Code (relating to special limitations on unused investment credits, work incentive program credits, new employee credits, alcohol fuel credits, foreign taxes, and capital losses), as in effect for taxable years beginning with and after the first taxable year to which the amendments made by the Tax Reform Act of 1976 apply, is amended—

(i) by inserting "to any unused credit of the corporation under section 44H(b)(2)(B)," after 44G(b)(2),", and

(ii) by inserting "JOB-TRAINING CREDITS," after "EMPLOYEE STOCK OWNERSHIP CREDITS," in the section heading.

(B) Section 383 of such Code (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) is amended—

(i) by inserting "to any unused credit of the corporation which could otherwise be carried forward under section 44H(b)(2)(B)," after "44G(b)(2),", and

(ii) by inserting "JOB-TRAINING CREDITS," after "EMPLOYEE STOCK OWNERSHIP CREDITS," in the section heading.

(C) The table of sections for part V of subchapter C of chapter 1 is amended by inserting "job-training credits," after "employee stock ownership credits," in the item relating to section 383.

(4) Subparagraph (C) of section 6511(d)(4) of such Code (defining credit carryback) is amended by striking out "and employee stock ownership credit carryback" and inserting in lieu thereof "employee stock ownership credit carryback, and job-training credit carryback".

(5) Section 6411 of such Code (relating to quick refunds in respect of tentative carryback adjustments) is amended—

(A) by striking out "or unused employee stock ownership credit" each place it appears and inserting in lieu thereof "unused employee stock ownership credit, or unused job-training credit";

(B) by inserting ", by a job-training credit carryback provided by section 44H(b)(2)" after "by an employee stock ownership credit carryback provided in section 44G(b)(2)," in the first sentence of subsection (a);

(C) by striking out "or an employee stock ownership credit carryback from" each place it appears and inserting in lieu thereof "an employee stock ownership credit carryback, or a job-training credit carryback from"; and

(D) by striking out "research and experimental credit carryback)" in the second sentence of subsection (a) and inserting in lieu thereof "research and experimental credit carryback, or, in the case of a job-training credit carryback, to an investment credit carryback, a new employee credit carryback, a research and experimental credit carryback, or an employee stock ownership credit carryback)".

(c)(1) Subsection (b) of section 6096 of such Code (relating to designation of income tax payments to Presidential Election Campaign Fund) is amended by striking out "and 44G" and inserting in lieu thereof "44G, and 44H".

(2) The table of sections for subpart A of part IV of subchapter A of chapter 1 of such Code is amended by inserting after the item relating to section 44G the following new item:

"Sec. 44H. Charitable contributions to qualified job-training organizations.".

(d) The amendments made by this section shall apply to taxable years beginning after December 31, 1981.

II

97TH CONGRESS
2D SESSION

S. 2547

To amend the Internal Revenue Code of 1954 to require recognition of gains by distributing corporation, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MAY 19 (legislative day, MAY 11), 1982

Mr. METZENBAUM introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to require recognition of gains by distributing corporation, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PARTIAL LIQUIDATIONS.

(a) IN GENERAL.—Section 346 of the Internal Revenue Code of 1954 (relating to partial liquidations) is hereby repealed.

(b) EFFECTIVE DATE.—The amendments made by this section shall apply with respect to distribution completed after the date of introduction of this bill.

SEC. 2. EXEMPTIONS AND LIMITATIONS TO RECOGNIZING GAIN BY A DISTRIBUTING CORPORATION.

(a) In General.—Paragraph (2) of section 311(d) of the Internal Revenue Code of 1954 (relating to appreciated property used to redeem stock) is amended by striking subparagraphs (A), (B), and (C) and redesignating subparagraphs (D), (E), (F), and (G), as subparagraphs (A), (B), (C), and (D) respectively.

(b) Effective Date.—The amendments made by this section shall apply with respect to distributions completed after the date of introduction of this bill.

SEC. 3. REDEMPTIONS TREATED AS EXCHANGES.

(a) In General.—Section 302(b) of the Internal Revenue Code of 1954 (relating to redemptions treated as exchanges) is amended by adding at the end thereof the following new paragraph:

"(5) Termination of a business.—For purposes of paragraph (1) of this subsection a redemption shall not be treated as essentially equivalent to a dividend if—

"(A) the distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part, and

"(B) immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of subparagraphs (A) and (B) of this paragraph shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.".

(b) Effective Date.—The amendments made by this section shall apply with respect to redemptions completed after the date of introduction of this bill.

II

97TH CONGRESS
2D SESSION

S. 2687

To change the tax treatment of partial liquidations and of certain distributions of appreciated property.

IN THE SENATE OF THE UNITED STATES

JUNE 29 (legislative day, JUNE 8), 1982

Mr. DANFORTH introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To change the tax treatment of partial liquidations and of certain distributions of appreciated property.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I—CHANGES IN TAX TREATMENT OF PARTIAL LIQUIDATIONS AND OF CERTAIN DISTRIBUTIONS OF APPRECIATED PROPERTY

SEC. 101. PARTIAL LIQUIDATIONS.

(a) SECTION 331 (WHICH PROVIDES CAPITAL GAIN OR LOSS TREATMENT FOR SHAREHOLDERS IN LIQUIDA-

TIONS) LIMITED TO COMPLETE LIQUIDATIONS.—Subsection (a) of section 331 (relating to gain or loss to shareholders in corporate liquidations) is amended to read as follows:

"(a) DISTRIBUTIONS IN COMPLETE LIQUIDATION TREATED AS EXCHANGES.—Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock.".

(b) SECTION 336 (WHICH PROVIDES NONRECOGNITION OF GAIN AND LOSS ON DISTRIBUTIONS BY LIQUIDATING CORPORATION) LIMITED TO COMPLETE LIQUIDATIONS.—Subsection (a) of section 336 (relating to distributions of property in liquidation) is amended by striking out "partial or complete liquidation" and inserting in lieu thereof "complete liquidation".

(c) CERTAIN DISTRIBUTIONS TO NONCORPORATE SHAREHOLDERS WHICH QUALIFY AS PARTIAL LIQUIDATIONS UNDER EXISTING LAW TREATED AS REDEMPTIONS.—Section 302 (relating to distributions in redemption of stock) is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) REDEMPTIONS FROM NONCORPORATE SHAREHOLDERS WHICH ARE ATTRIBUTABLE TO TERMINATION OR DISTRIBUTION OF BUSINESS.—

"(1) IN GENERAL.—For purposes of this section, a redemption of stock held by a shareholder who is not a corporation shall be treated as not essentially equivalent to a dividend if the requirements of subparagraphs (A) and (B) of this paragraph are met:

"(A) The redemption is attributable to the distributing corporation's ceasing to conduct, or consists of the assets of, a qualified trade or business.

"(B) Immediately after the redemption the distributing corporation is actively engaged in the conduct of a qualified trade or business.

"(2) QUALIFIED TRADE OR BUSINESS.—For purposes of paragraph (1), the term 'qualified trade or business' means any trade or business which—

"(A) was actively conducted throughout the 5-year period ending on the date of the redemption, and

"(B) was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

"(3) REDEMPTION MAY BE PRO RATA.—Whether or not a redemption meets the requirements of subparagraphs (A) and (B) of paragraph (1) shall be determined without regard to whether or not the redemption is pro rata with respect to all of the shareholders of the corporation.".

(d) DEFINITION AND SPECIAL RULE.—Section 346 (defining partial liquidation) is amended to read as follows:

"SEC. 346. DEFINITION AND SPECIAL RULE.

"(a) COMPLETE LIQUIDATION.—For purposes of this subchapter, a distribution shall be treated as in complete liquidation of a corporation if the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan.

"(b) TRANSACTIONS WHICH MIGHT REACH SAME RESULT AS PARTIAL LIQUIDATIONS.—The Secretary shall prescribe such regulations as may be necessary to ensure that the purposes of subsections (a) and (b) of section 101 of the Corporate Takeover Tax Act of 1982 repealing the special tax treatment for partial liquidations may not be circumvented through the use of section 355, 351, 337, or any other provision of law or regulations (including the consolidated return regulations).".

(e) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) The following provisions are each amended by striking out "partial or complete liquidation" and inserting in lieu thereof "complete liquidation":

(A) Subsection (b) of section 331 (relating to nonapplication of section 301).

(B) Subsection (a) of section 334 (relating to basis of property received in liquidations).

(C) Paragraph (1) of section 336(b) (relating to distributions of LIFO inventory).

(D) Paragraph (2) of section 341(a) (relating to collapsible corporations).

(2)(A) The heading and table of sections for subpart D of part II of subchapter C of chapter 1 is amended to read as follows:

"Subpart D—Definition and Special Rule

"Sec. 346. Definition and special rule.".

(B) The table of subparts for such part II is amended by amending the item relating to subpart D to read as follows:

"Subpart D. Definition and special rule.".

SEC. 102. DISTRIBUTION OF APPRECIATED PROPERTY IN REDEMPTION OF STOCK.

(a) IN GENERAL.—Paragraph (2) of section 311(d) (relating to recognition of gain on distribution of appreciated property in redemption of stock) is amended by striking out subparagraphs (A), (B), (C), and (G).

(b) CONFORMING AMENDMENTS.—Paragraph (2) of section 311(d) is amended—

(1) by redesignating subparagraphs (D), (E), and (F) as subparagraphs (A), (B), and (C), respectively,

(2) by adding "and" at the end of subparagraph (B) (as so redesignated), and

(3) by striking out "; and" at the end of subparagraph (C) (as so redesignated) and inserting in lieu thereof a period.

SEC. 103. EFFECTIVE DATE.

The amendments made by this title shall apply to distributions after August 31, 1982.

TITLE II—CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES

SEC. 201. CERTAIN STOCK PURCHASES TREATED AS ASSET PURCHASES.

(a) GENERAL RULE.—Subpart B of part II of subchapter C of chapter 1 (relating to effects on corporation) is amended by adding at the end thereof the following new section:

"SEC. 338. CERTAIN STOCK PURCHASES TREATED AS ASSET ACQUISITIONS.

"(a) GENERAL RULE.—For purposes of this title, if a purchasing corporation makes an election under this section (or is treated under subsection (d) as having made such an election), then in the case of any qualified stock purchase, the target corporation—

"(1) shall be treated as having sold all of its assets on the acquisition date in a single transaction to which section 337 applies, and

"(2) immediately after such sale, shall be treated as a new corporation which purchased all of the assets referred to in paragraph (1).

"(b) PRICE AT WHICH DEEMED SALE MADE.—For purposes of subsection (a), the assets of the target corporation shall be treated as sold (and purchased) at an amount equal to—

"(1) the basis of the purchasing corporation's stock in the target corporation on whichever of the following days such basis is greater—

"(A) the acquisition date, or

"(B) the last day of the 12-month acquisition period,

"(2) properly adjusted under regulations prescribed by the Secretary for liabilities of the target corporation and other relevant items.

Such amount shall be allocated among the assets of the target corporation under regulations prescribed by the Secretary.

"(c) PURCHASING CORPORATION; TARGET CORPORATION; QUALIFIED STOCK PURCHASE.—For purposes of this section—

"(1) PURCHASING CORPORATION.—The term 'purchasing corporation' means any corporation which makes a qualified stock purchase of stock of another corporation.

"(2) TARGET CORPORATION.—The term 'target corporation' means any corporation the stock of which is acquired by another corporation in a qualified stock purchase.

"(3) QUALIFIED STOCK PURCHASE.—The term 'qualified stock purchase' means any transaction or series of transactions in which stock of one corporation possessing—

"(A) at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and

"(B) at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends),

is acquired by another corporation by purchase during the 12-month acquisition period.

"(d) DEEMED ELECTION WHERE PURCHASING CORPORATION ACQUIRES ASSET OF TARGET CORPORATION.—

"(1) IN GENERAL.—A purchasing corporation shall be treated as having made an election under this section with respect to any target corporation if, at any time during the consistency period, it acquires any asset of the target corporation (or a target affiliate).

"(2) EXCEPTIONS.—Paragraph (1) shall not apply with respect to any acquisition by the purchasing corporation if—

"(A) such acquisition is pursuant to a sale by the target corporation (or the target affiliate) in the ordinary course of its trade or business, or

"(B) the basis of the property acquired is determined (in whole or in part) by reference to the adjusted basis of such property in the hands of the person from whom acquired.

"(3) ANTI-AVOIDANCE RULE.—Whenever necessary to carry out the purposes of this subsection and subsection (e), the Secretary may treat stock acquisitions which are pursuant to a plan and which meet the 80 percent requires of subparagraphs (A) and (B) of subsection (c)(3) as qualified stock purchases.

"(e) CONSISTENCY REQUIRED FOR ALL STOCK ACQUISITIONS FROM SAME AFFILIATED GROUP.—

"(1) IN GENERAL.—If a purchasing corporation makes qualified stock purchases with respect to the target corporation and one or more target affiliates during any consistency period, then (except as otherwise provided in subsection (d))—

"(A) any election under this section with respect to the first such purchase shall apply to each other such purchase, and

"(B) no election may be made under this section with respect to the second or subsequent such purchase if such an election was not made with respect to the first such purchase.

"(2) ASSET PURCHASE TREATED AS STOCK PURCHASE.—

"(A) IN GENERAL.—For purposes of paragraph (1), the acquisition by the purchasing corporation of any asset of another corporation shall be treated as a qualified stock purchase with respect to which an election under this section was made.

"(B) EXCEPTIONS.—Subparagraph (A) shall not apply to any acquisition described in subsection (D)(2).

"(f) ELECTION.—

"(1) WHEN MADE.—Except as otherwise provided in regulations, an election under this section shall be made not later than 75 days after the acquisition date.

"(2) MANNER.—An election by the purchasing corporation under this section shall be made in such manner as the Secretary shall by regulations prescribe.

"(3) ELECTION IRREVOCABLE.—An election by a purchasing corporation under this section, once made, shall be irrevocable.

"(g) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

"(1) 12-MONTH ACQUISITION PERIOD.—The term '12-month acquisition period' means the 12-month period beginning with the earlier of—

"(A) the date of the first acquisition by purchase of stock included in a qualified stock purchase, or

"(B) if any of such stock was acquired in an acquisition which was a purchase within the meaning of subparagraph (B) of paragraph (3), the date on which the purchasing corporation is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made.

"(2) ACQUISITION DATE.—The term 'acquisition date' means, with respect to any corporation, the first day on which there is a qualified stock purchase with respect to the stock of such corporation.

"(3) PURCHASE.—

"(A) IN GENERAL.—The term 'purchase' means any acquisition of stock, but only if—

"(i) the basis of the stock in the hands of the purchasing corporation is not determined (I) in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom acquired, or (II) under section 1014(a) (relating to property acquired from a decedent),

"(ii) the stock is not acquired in an exchange to which section 351 applies, and

"(iii) the stock is not acquired from a person the ownership of whose stock would, under section 318(a), be attributed to the person acquiring such stock.

"(B) DEEMED PURCHASE OF STOCK OF SUBSIDIARIES.—If stock in a corporation is acquired by purchase (within the meaning of subparagraph (A)) and, as a result of such acquisition, the purchasing corporation is treated (by reason of section 318(a)) as owning stock in a third corporation, the purchasing corporation shall be treated as having purchased such stock in such third corporation. The purchasing corporation shall not be treated as acquiring stock in the third corporation by reason of the preceding sentence before the first day on which the purchasing corporation is considered under section 318(a) as owning such stock.

"(4) CONSISTENCY PERIOD.—

"(A) IN GENERAL.—Except as provided in subparagraph (B), the term 'consistency period' means the period consisting of—

"(i) the 1-year period before the beginning of the 12-month acquisition period for the target corporation,

"(ii) such acquisition period (up to and including the acquisition date), and

"(iii) the 1-year period beginning on the day after the acquisition date.

"(B) EXTENSION WHERE THERE IS PLAN.—The period referred to in subparagraph (A) shall also include any period during which there was in effect a plan to make a qualified stock purchase plus one or more other qualified stock purchases (or asset acquisitions described in subsection (d)) with respect to the target corporation or any target affiliate.

"(5) AFFILIATED GROUP.—The term 'affiliated group' has the meaning given to such term by section 1504(a) (determined without regard to the exceptions contained in section 1504(b)).

"(6) TARGET AFFILIATE.—A corporation shall be treated as a target affiliate of the target corporation if each of such corporations was, at any time during the 18-month period ending on its acquisition date, a member of an affiliated group which had the same common parent.

"(7) ACQUISITIONS BY PURCHASING CORPORATION INCLUDE ACQUISITIONS BY CORPORATIONS AFFILIATED WITH PURCHASING CORPORATION.—Except as otherwise provided in regulations, an acquisition of stock or assets by any member of an affiliated group which includes a purchasing corporation shall be treated as made by the purchasing corporation.

"(h) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary to ensure that the purposes of this section to require consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates (whether by treating all of them as stock purchases or as asset purchases) may not be circumvented through the use of any provision of law or regulations (including the consolidated return regulations).".

(b) REPEAL OF SECTION 334(b)(2).—Subsection (b) of section 334 (relating to limitation of subsidiary) is amended to read as follows:

"(b) LIQUIDATION OF SUBSIDIARY.—

"(1) DISTRIBUTION IN COMPLETE LIQUIDATION.—If property is received by a corporation in a distribution in a complete liquidation to which section 332(a) applies, the basis of the property in the hands of the distributee shall be the same as it would be in the hands of the transferor.

"(2) TRANSFERS TO WHICH SECTION 332(C) APPLIES.—If property is received by a corporation in a transfer to which section 332(c) applies, the basis of the property in the hands of the transferee shall be the same as it would be in the hands of the transferor.

"(3) DISTRIBUTEE DEFINED.—For purposes of this subsection, the term 'distributee' means only the corporation which meets the 80-percent stock ownership requirements specified in section 332(b).".

(c) TECHNICAL AMENDMENTS.—

(1) Subparagraph (E) of section 168(e)(4) (relating to liquidation of subsidiary, etc.) is amended by adding at the end thereof the following new sentence: "A similiar rule shall apply in the case of a deemed liquidation under section 338.".

(2) Clause (i) of section 168(f)(10)(B) is amended by striking out "section 334(b)(2)" and inserting in lieu thereof "section 334(b)(2) or 338".

(3) Paragraph (4) of section 318(b) is amended to read as follows:

"(4) section 338(c)(3)(B) (relating to purchase of stock from subsidiaries, etc.);".

(4) Paragraph (2) of section 336(b) is amended by striking out "334(b)(1)" each place it appears and inserting in lieu thereof "334(b)".

(5) Paragraph (2) of section 337(c) (relating to liquidations to which section 332 applies) is amended to read as follows:

"(2). LIQUIDATIONS TO WHICH SECTION 332 APPLIES.—In the case of any sale or exchange following the adoption of a plan of complete liquidation, if section 332 applies with respect to such liquidation, this section shall not apply.".

(6) Paragraph (1) of section 381(a) is amended by striking out ", except in a case in which the basis of the assets distributed is determined under section 334(b)(2)".

(7) Subparagraph (B) of section 617(h)(2) is amended by inserting "338," after "334(b),".

(8) The table of sections for subpart B of part II of subchapter C of chapter 1 is amended by adding at the end thereof the following:

"Sec. 338. Certain stock purchases treated as asset acquisitions.".

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to any target corporation (within the meaning of section 338 of the Internal Revenue Code of 1954 as added by this section) with respect to which the acquisition date (within the meaning of such section) occurs after August 31, 1982.

DESCRIPTION OF S. 2224

TAX CREDIT FOR CONTRIBUTIONS TO PROGRAMS PROVIDING JOB TRAINING TO CERTAIN INDIVIDUALS

Scheduled for a Hearing
on
July 15, 1982
by the
Committee on Finance

Prepared by the Staff
of the
Joint Committee on Taxation

July 14, 1982
JCX-30-82

INTRODUCTION

This document describes S. 2224 (Senator Specter), which would provide a tax credit for contributions to charitable organizations that provide job training for handicapped and economically disadvantaged individuals and displaced workers. The bill is scheduled for a hearing on July 15, 1982, by the Committee on Finance.

I. SUMMARY

Under present law, contributions to tax-exempt organizations generally are deductible. Tax credits, however, are not permitted for charitable contributions to tax-exempt organizations that provide job training nor are they permitted for charitable contributions in general.

The bill would provide a tax credit equal to 20 percent of charitable contributions made to tax-exempt organizations that provide job training exclusively to handicapped or economically disadvantaged individuals or to displaced workers. The credit would be nonrefundable and could not exceed $250,000. The bill would apply to contributions made in taxable years beginning after December 31, 1981.

II. DESCRIPTION OF THE BILL

Present Law

Present law generally allows income tax deductions for charitable contributions (Code sec. 170). The term "charitable contribution" generally includes a contribution or gift to, or for the use of, an organization that is organized and operated exclusively for one of the purposes enumerated in section 501(c)(3) 1/. The providing of job training and guidance to unskilled and under-employed workers may qualify as a charitable purpose so long as the manner of its achievement is otherwise charitable.2/ Tax credits are not provided for charitable contributions.

Explanation of the Bill

The bill would allow as a credit against tax an amount equal to 20 percent of the qualified job-training charitable contributions of the taxpayer for the taxable year.

A qualified job-training charitable contribution would be a charitable contribution to a qualified job-training organization. A qualified job-training organization would be an organization that meets the following two requirements: (1) it is exempt from tax under Code section 501(a) as an organization described in section 501(c)(3) and (2) it is certified by the appropriate regional office of Employment and Training Administration of the Department of Labor as providing job training solely to handicapped individuals, economically disadvantaged

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1/ Code sec. 501(a) provides for the exemption from Federal income tax of certain organizations that are "organized and operated exclusively for religious, charitable, scientific, or educational purposes . . . no part of the net earnings of which inures to the benefit of any private shareholder or individual," and which meet certain other specified requirements.

2/ See Rev. Rul. 67-72, 1967-1 C.B. 125 and Rev. Rul. 68-504, 1968-2 C.B. 211.

individuals, or displaced workers (or to any combination of these individuals).3/

Limitations on credit

The maximum amount of credit for any taxpayer would be $250,000. Furthermore, the credit could not exceed a taxpayer's tax liability, as reduced by other allowable credits.

If the amount of a taxpayer's credit exceeds tax liability, then that amount could be carried back to each of the three taxable years preceding the year of the excess credit, and could be carried forward to each of the fifteen taxable years following the year of the excess credit.

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[3] Job training, for purposes of the bill, would be instruction in vocational and other skills necessary to obtain employment or a higher grade of employment.

A handicapped individual would be an individual who has a physical or mental disability which for that individual constitutes or results in a substantial handicap to employment, and who can reasonably be expected to obtain employment, or a higher grade of employment, as a result of job training.

An economically disadvantaged individual would be any individual who (1) receives cash welfare payments under a Federal, State, or local welfare program; (2) has an income, for the 6-month period before applying for job training, that would have met the qualifications for Federal, State, or local welfare payments or, if computed on an annual basis, would not exceed the poverty level established by the Director of the Office of Management and Budget; or (3) is a member of a family that meets either of these requirements.

A displaced worker would be an individual who (1) was employed by an establishment on a full-time basis for at least one year; (2) was not employed by the establishment in an executive, administrative, or professional capacity; and (3) is currently unemployed because of a change in the technology of such establishment, or a total or partial closing of such establishment by reason of competing technology.

Special rules

In the case of a controlled group of corporations, all members of the same controlled group would be treated as a single taxpayer, and the credit (if any) allowable to each member would be the proportionate share of qualified job-training charitable contributions giving rise to the credit.

In the case of subchapter S corporations, the credit would be apportioned pro rata among the shareholders.

In the case of an estate or trust, the credit would be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each.

In the case of partnerships, the credit would be allocated among the partners under regulations to be prescribed by the Treasury.

Special rules also would be provided with respect to carryovers of the credit in certain corporate acquisitions.

Effective Date

The bill would apply to taxable years beginning after December 31, 1981.

DESCRIPTION OF S. 2687 AND S. 2547

Relating to

TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS

Scheduled for a Hearing
on July 15, 1982
By the
Senate Committee on Finance

Prepared by the Staff
of the
Joint Committee on Taxation

July 14, 1982
JCX-29-82

INTRODUCTION

This document provides a description of the provisions of S. 2687 (Senator Danforth) and S. 2547 (Senator Metzenbaum), relating to the tax treatment of corporate mergers and acquisitions. These bills are scheduled for a public hearing on July 15, 1982, by the Senate Committee on Finance.

The changes included in S. 2687 correspond to those approved by the Committee on Finance in its amendment to H. R. 4961 (secs. 226-227 and 229 of the bill as reported; S. Rept. No. 97-494,Vol. 1, July 12, 1982).

The first part of the document is a summary of principal changes made by the bills compared to present law. This is followed by a more detailed description of the provisions of the bills and present law.

Summary of Principal Changes Made by S. 2687 and S. 2547

Subject	Present Law	S. 2687[1]
Treatment of corporation distributing property in partial liquidation	Gain or loss not recognized to corporation but recapture rules apply.	Same, if distribution is made without redeeming stock from shareholders. Gain recognized if stock is redeemed. [2]
Treatment of shareholders on partial liquidation	Gain or loss recognized with respect to stock redeemed, generally capital gain or loss.	Same only if there is a non-pro rata stock redemption. If stock is redeemed pro rata, or the property is distributed without redeeming stock, generally will be a dividend to shareholders. Capital gain treatment preserved for noncorporate shareholders where 5-year old trade or business is distributed pro rata. S. 2547 would provide such treatment to corporate shareholders as well. [2]
Nonliquidating redemptions of stock for appreciated property	Gain or loss, generally capital gain or loss, to shareholders if redemption is not pro rata. If pro rata, may be a dividend. Gain but not loss, is recognized to corporation but with several exceptions.	Same, but most exceptions to the requirement that gain is recognized to the corporation would be repealed. [2]
Stock purchase treated as asset purchase	Applies where 80 percent of acquired corporation's stock purchased by purchasing corporation within one year and subsidiary is liquidated. May take up to 5 years after stock purchase to liquidate, but plan to liquidate must be adopted within 2 years of purchase.	Within 75 days after qualifying stock purchase, purchasing corporation may elect to treat transaction as if subsidiary sold all its assets on stock purchase date and is thereafter a new corporation which bought the assets. No actual liquidation required.

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[1] All changes proposed by S. 2687 correspond to those agreed to by the Finance Committee at an executive session on July 1 and 2, 1982.

[2] These changes are proposed in both S. 2687 and S. 2547. No other changes are proposed by S. 2547.

Summary of Principal Changes Made by S. 2687 and S. 2547

Subject	Present Law	S. 2687
Purchase of assets from corporation and purchase concurrently of the selling corporation's stock	If acquired subsidiary is not liquidated under the asset purchase rule, transaction is both an asset purchase and continuation of subsidiary.	Transaction will be treated as wholly an asset purchase, as if election made with respect to purchased subsidiary.
Purchase of several corporations that are members of the same affiliated group	By complying with asset purchase rules, liquidation of one or more corporations may be treated as asset purchases while continuing one or more other corporations.	Must elect to treat all acquired affiliates as if assets were sold or treat all acquired corporations as continuing.
Purchase of assets from a corporation and purchase of the stock of an affiliated corporation	Asset purchase plus continuation of the acquired subsidiary if it is not liquidated under the asset purchase rules.	Deemed to be entirely a purchase and sale of assets as if election made for acquired subsidiary.

Under S. 2687, the effective date for the changes relating to the treatment of partial liquidations and stock redemptions apply in the case of distributions after August 31, 1982. Changes relating to the treatment of stock purchases as asset purchases apply where the date of acquisition (of 80 percent or more of the acquired corporation's stock) occurs after August 31, 1982. The effective dates of the changes agreed to by the committee are the same except that the changes relating to the treatment of partial liquidations would not apply to distributions pursuant to a plan of liquidation adopted on or before October 1, 1982, by a corporation a majority of the shares of which were acquired pursuant to a tender offer outstanding on July 1, 1982, or a binding contract entered into before that date. S. 2547 applies with respect to distributions after May 19, 1982 (the date of the bill's introduction).

S. 2687--Senator Danforth
and
S. 2547--Senator Metzenbaum

Overview

The provisions of S. 2687 are intended to accomplish the following objectives:

1. If a distribution to shareholders of appreciated property by an ongoing corporation with continuing tax attributes is treated as a taxable exchange of stock by the shareholders, gain should be recognized by the distributing corporation to the same extent as would be required on a direct sale of the assets. S. 2547 is also addressed to this objective.

2. The basis of purchased assets is their cost, generally current fair market value, and they carry none of the tax attributes of the selling corporation. The basis of assets and other tax attributes of an acquired corporation are unaffected by the purchase of its stock. Consistency of treatment should be required in corporate takeovers to eliminate any tax advantage in selectively structuring the acquisition as in part a purchase of assets and in part a purchase of stock.

3. A purchase of one corporation's stock by another corporation may be treated as a purchase of the acquired corporation's assets under present law if the acquired corporation is liquidated in accordance with certain statutory requirements. Compliance, or failure to comply, with those requirements makes such treatment essentially elective. The tax attributes of the acquired corporation continue until it is liquidated. Elective treatment should be expressly provided rather than implicit and asset purchase treatment if elected should apply as of the time the stock is purchased in order to equate asset purchase treatment with an actual asset purchase. Such elective treatment should not require an actual liquidation.

S. 2547 and TITLE I of S. 2687

In general

S. 2547 and Title I of S. 2687 require a corporation that distributes appreciated property in redemption of part of its stock to recognize gain, as it would be required to do if it sold its assets.

Partial Liquidations--Background

Principally S. 2547 and Title I of S. 2687 affect transactions that qualify as partial liquidations under present law. A distribution of assets by a corporation in redemption of its stock qualifies as a partial liquidation if it results in a significant contraction of the distributing corporation's business operations. There is no gain or loss recognized to the corporation except for recapture tax with respect to prior depreciation, investment tax credit, and other items. Gain or loss to the shareholders resulting from the exchange of part of their stock for the assets in most cases is capital gain or loss. The fair market value of the distributed assets at the time of distribution becomes the basis to the shareholders.

If one corporation purchases stock of another and thereafter receives a distribution of business assets in a redemption of the purchased stock in a transaction qualifying as a partial liquidation, the transaction is similar to a direct purchase of the assets except that the distributing corporation is not required to recognize gain. If one corporation acquires control of another (80 percent of the stock) and consolidated returns are filed, recapture tax is deferred or avoided on a partial liquidation of the acquired corporation under the regulations.

The partial liquidation provisions may be used to selectively step up the basis of assets in an acquired subsidiary to obtain increased depletion and depreciation deductions and other tax benefits without recognition of gain. For example, assume a subsidiary corporation has two groups of assets. One group of assets has a low basis due to prior depletion deductions and no potential recapture tax liability. The other group of assets has a large recapture tax potential. To obtain increased depletion deductions on the first group and avoid recapture on the second group, S distributes the first group of assets to P in a transaction that qualifies as a partial liquidation. No tax is paid by S on the transaction and P gets a stepped-up basis in the distributed assets that will permit increased depletion deductions. The tax attributes of S are unaffected and P continues to have control over the S assets. The transaction thus permits the step-up in basis that would occur if the assets were purchased by P but does not impose the tax against S that would apply if the assets were sold by S. If the assets were distributed as a dividend by S, the disparity of treatment would not occur. Gain would not be recognized to S but P would not get a stepped-up basis (the basis of assets distributed to a corporate shareholder as a dividend is limited to the distributor's basis adjusted for recapture items).

A partial liquidation, whether or not it is within a corporate takeover context, often resembles a normal corporate dividend where the distributing corporation has sufficient earnings and profits, the distribution is pro rata among the shareholders, and the distributing corporation remains as a continuing business enterprise.

Proposal

The change proposed by S. 2547 and Title I of S. 2687 repeals the partial liquidation provisions of present law except that it preserves capital gain treatment for noncorporate shareholders in a limited case, i.e., where the distribution results from the corporation's ceasing to conduct a 5-year old trade or business and the distributing corporation continues to conduct a separate 5-year business.3/ For other distributions now classified as partial liquidations, repeal will result in a dividend. The distributing corporation making an in-kind dividend is taxed on recapture items but does not recognize gain otherwise. A corporate shareholder receiving an in-kind dividend has a carryover basis for the distributed assets and thus the transaction does not resemble a purchase of assets stepping up basis without gain recognition. Basis of assets distributed as a dividend to noncorporate shareholders do acquire a fair market value basis but the full amount of the distribution constitutes ordinary income to the shareholders.

Stock Redemptions--Background

Under present law, when a corporation distributes appreciated assets to one or more shareholders in redemption of part of its stock in a transaction not qualifying as a partial liquidation, gain is generally recognized both to the distributing corporation and to those shareholders exchanging their stock. There are several exceptions to the requirement that gain must be recognized to the distributing corporation. These exceptions permit a basis step-up on the one hand as though the assets were purchased by the shareholders, and no gain recognition on the other, as though the assets were distributed in the normal course of the corporation's business. These exceptions put a premium on having asset distributions take the form of stock redemptions.

To illustrate, one such exception applies where the distribution consists of stock in a subisdiary corporation more than 50 percent owned by the distributing corporation. If stock in the subsidiary corporation were sold directly by the parent corporation, taxable gain would be recognized to the parent. Instead, the buyer might purchase stock in the parent and thereafter receive the subsidiary's stock in a distribution redeeming the parent's stock. The transaction is essentially similar to a direct sale of the subsidiary's stock except that, under the described exception, the parent corporation is not required to recognize gain.

If a stock purchase followed by its redemption for appreciated property are pursuant to a plan, present law may result in treating the transaction as a direct purchase of assets. This

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3/ S. 2547 would preserve capital gain treatment for corporate shareholders as well in these cases.

treatment is clearly inapplicable to many stock redemptions and its application in other cases will remain uncertain unless mandated by statute.

Proposal

The bills would repeal most of the exceptions to the provision that requires gain recognition to the distributing corporation on a distribution of appreciated property in a stock redemption.

General Effect of S. 2547 and Title I of S. 2687

The repeal of the partial liquidation rules and the exceptions to the requirement that gain be recognized on distributions of appreciated property in stock redemptions will provide greater tax neutrality between corporate acquisitions through stock purchases and through direct asset purchases.

TITLE II of S. 2687

In general

Title II of S. 2687 would permit a corporation, after a purchase of the stock of a target corporation, to elect to treat the target corporation as if it sold all its assets in the course of a complete liquidation. Consistency of treatment would be required where several affiliated corporations are purchased or both stock purchases and direct asset purchases are made from the same affiliated group.

Stock Purchase Treated as Asset Purchase--Background

Under present law, when a corporation sells its assets and distributes the proceeds in a complete liquidation, gain is not recognized by the liquidating corporation except for recapture items, and the purchaser obtains a fair market value basis in the purchased assets. To obtain nonrecognition treatment, the sale and liquidation must occur within a one-year period.

Gain also is not recognized by the liquidating corporation if instead of purchasing the assets directly from the liquidating corporation, a corporate purchaser buys 80 percent or more of the stock of the corporation and then liquidates it. The basis in the assets is stepped up to reflect the purchase price of the stock. In effect, the stock purchase is treated as an asset purchase. However, unlike the rules requiring that sales in liquidation occur within a one-year period, the rules governing liquidation of a recently purchased subsidiary do not require liquidation until 5 years after the stock acquisition. The acquired subsidiary has two years to adopt a plan of liquidation and three years after adoption of the plan to actually liquidate. During the interim, the acquired corporation is affiliated with its parent and is included on the latter's consolidated return if one is filed. The bases for the subsidiary's assets and its other tax attributes continue. Because of interim earnings, distributions, sales of assets and other items by the acquired corporation between the stock purchase and ultimate liquidation, complex adjustments are required that lead to inappropriate results in some cases. Recapture income of the subsidiary may be offset against losses of the acquiring corporation on a consolidated return, a result unavailable when assets are directly purchased.

With the exception of the treatment of a liquidation of a recently purchased subsidiary, the treatment of a purchase of assets from a corporation and the treatment of a purchase of a corporation's stock are different. A purchase of assets results in a stepped-up, fair market value basis whereas a purchase of stock that is not followed by a liquidation does not affect the basis of the acquired corporation's assets. A purchase of assets generally carries none of the other tax attributes of the selling corporation whereas those attributes continue and may be exploited on a consolidated return when one corporation acquires control of another. To maximize the tax advantages in a corporate takeover, selectivity can be fostered by structuring the transaction as partly a purchase of assets and partly a stock purchase or, through having the seller form itself into several corporations, as a purchase of several corporations with some being treated as asset purchases via qualifying liquidations while preserving asset basis and tax attributes in others.

Proposal

Title II of S. 2687 would replace the present law provision treating a stock purchase as an asset purchase with an election, to be made within 75 days after 80 percent or more of the acquired subsidiary's stock is purchased, to treat the acquired subsidiary as if it sold all its assets in a complete liquidation on the stock purchase date. No actual liquidation would be required. The basis of the assets would be adjusted to reflect the cost of the stock as of the stock purchase date and other tax attributes of the acquired corporation would terminate as of that date. The subsidiary would be treated as a new corporation that purchased the assets and only the "new" corporation would join in the acquiring corporation's consolidated return. The interim adjustments required under the existing rules treating subsidiary liquidations as asset purchases would not be required.

In addition, Title II requires consistency of treatment where the same corporation, or the same affiliated group, either purchases assets directly plus a controlling stock interest or purchases two or more corporations from the same selling group. This consistency would be required for purchases over a limited period of time, generally one year. Under this rule, purchases of assets generally would be controlling and require asset purchase treatment with respect to stock acquisitions. Where there are no direct asset acquisitions, but several subsidiaries are acquired, a consistent election would be required and, if asset acquisition treatment is not elected for the first subsidiary acquired, could not be made for subsequent acquisitions.

Revenue Effect

It is estimated that the provisions of S. 2687 would increase budget receipts by$693 million in fiscal year 1983, $824 million in fiscal year 1984, $745 million in fiscal year 1985, $661 million in fiscal year 1986, and $572 million in fiscal year 1987.

Danforth's Opening Statement, Corporate Takeover Act, Finance Committee Hearing—July 15, 1982

Mr. Chairman, I would like to say a few words about this provision before we hear from our distinguished group of witnesses. The objective of this bill is to revise provisions of current law which provide special tax benefits to corporations acquiring other corporations in certain transactions. Mr. Chairman, in general terms, I am disturbed by the lack of response to the incentives for new investment in productive plant and equipment and research and development which the Congress provided American business almost exactly a year ago. Since then, not only have corporations not moved to modernize as we hoped they would, it is generally agreed that by the end of 1982, there will actually have been *less* investment in new productive assets and R&D than in 1981.

The question one must ask is, what is business doing, if it is not taking advantage of these incentives to help push our economy into a strong recovery, what are they doing?

One thing they are taking advantage of is the fact that their outstanding stock is undervalued compared to the value of their underlying assets by buying up their own treasury stock. This is the opposite of what we intended with the Economic Recovery Tax Act, which was growth and expansion. Instead, these companies are

ADOPTING CONTRACTION AS THEIR CORPORATE POLICY. THIS PARTICULAR ACTIVITY IS THE SUBJECT OF A BILL WHICH I INTRODUCED IN JUNE, WHICH IS NOT PART OF THE COMMITTEE'S PACKAGE.

A SECOND THING CORPORATIONS ARE TAKING ADVANTAGE OF IS THE FACT THAT THEIR OUTSTANDING DEBT HAS DROPPED IN VALUE AS A RESULT OF CONTINUING HIGH INTEREST RATES. THE LAW AFTER THE ADOPTION OF THE BANKRUPTCY TAX ACT OF 1980 ALLOWS CORPORATIONS TO RETIRE THEIR DEBT WITH STOCK WITHOUT GAIN RECOGNITION. THUS IF A CORPORATION ISSUES $600 WORTH OF ITS STOCK TO RETIRE A $1,000 BOND, IT RECOGNIZES NO GAIN, EVEN THOUGH, HAD IT PAID $600 CASH TO RETIRE THE BOND IT WOULD HAVE HAD TO RECOGNIZE $400 OF GAIN, AND EVEN THOUGH, IN MANY CASES, THE ORIGINAL OWNER OF THE BOND HAS RECOGNIZED A $400 LOSS FOR TAX PURPOSES.

THIS SITUATION IS THE SUBJECT OF ANOTHER BILL I INTRODUCED LAST MONTH, WHICH IS NOT INCLUDED IN THE COMMITTEE'S PACKAGE. MR. CHAIRMAN, I BELIEVE THAT THESE SITUATIONS ARE VERY SERIOUS AND I HOPE THAT WE CAN HOLD HEARINGS ON BOTH OF THESE BILLS IN THE NEAR FUTURE.

ANOTHER THING CORPORATIONS ARE TAKING ADVANTAGE OF THESE DAYS IS CORPORATE TAKEOVER OPPORTUNITIES, AND TOO OFTEN THEY OCCUR BECAUSE OF THE INCENTIVES CURRENT TAX LAW PROVIDES. IT IS THIS ACITIVITY WHICH IS THE SUBJECT OF MY BILL WHICH IS INCLUDED IN THE COMMITTEE'S PACKAGE.

AS WITH A POLICY OF CORPORATE CONTRACTION, TAKEOVERS, PARTICULARLY THOSE WHICH ARE SIGNIFICANTLY MOTIVATED BY TAX CONSIDERATIONS, CONTRIBUTE VIRTUALLY NOTHING TO OUR ECONOMIC RECOVERY. IN FACT, IT IS MY VIEW THAT THIS TYPE OF ACTIVITY HAS CONTRIBUTED TO THE PERSISTENCE AND SEVERITY OF THIS RECESSION.

WE'VE ALL READ ABOUT DOZENS OF TAKEOVER ATTEMPTS ON THE PART OF THIS COUNTRY'S LEADING CORPORATIONS DURING THE PAST YEAR OR SO. IN THE USUAL CASE, THESE TRANSACTIONS TIE UP HUNDREDS OF MILLIONS OF DOLLARS OF INVESTMENT CAPITAL, WHICH NOT ONLY ADDS PRESSURE TO INTEREST RATES, BUT PREVENTS THE INVESTMENT OF THAT CAPITAL IN PRODUCTIVE ASSETS. I HAVE YET TO READ ABOUT A TAKEOVER THAT PRODUCED ONE NEW JOB. IN FACT, I'M CONFIDENT IT COULD BE DEMONSTRATED THAT IN EVERY CASE, JOBS ARE ACTUALLY LOST. THIS HAS A DEVASTATING EFFECT ON THE LOCAL ECONOMY WHERE THE TARGET CORPORATION IS LOCATED, AND ON A COLLECTIVE BASIS HAS, I'M CONVINCED, CONTRIBUTED SIGNIFICANTLY TO THE NATION'S ECONOMIC WOES.

MR. CHAIRMAN, THIS COMMITTEE DOES NOT HAVE THE JURISDICTION TO DECIDE WHETHER MERGERS AND TAKEOVERS ARE GOOD OR BAD -- THE JUDICIARY COMMITTEE ON WHICH YOU AND SENATORS GRASSLEY AND BAUCUS SIT, HAS THAT POWER. BUT THIS COMMITTEE DOES HAVE THE JURISDICTION AND, I BELIEVE, THE RESPONSIBILITY, TO ENSURE THAT THE TAX SYSTEM IS NEUTRAL WITH RESPECT TO CORPORATE TAKEOVERS AS POSSIBLE. IT SHOULD PROVIDE NEITHER SPECIAL BENEFITS FROM, NOR IMPEDIMENTS TO, MERGERS AND ACQUISITIONS.

BUT PRESENT LAW, IN MANY CIRCUMSTANCES, DOES PROVIDE TAX INCENTIVES WHICH MAY ENCOURAGE TAKEOVERS WITHOUT REGARD TO WHETHER THE TRANSACTION PRESENTS AN OPPORTUNITY TO IMPROVE THE UTILIZATION OF PRODUCTIVE INVESTMENT. IN SUCH CASES, NOT ONLY DOES THE TAX SYSTEM ENCOURAGE THE TRANSACTION, THE EFFECT IS THE SAME AS IF THE TREASURY DEPARTMENT HAD HELPED FINANCE THE TAKEOVER.

THE BILL IS DESIGNED TO REMOVE THE MORE BLATANT OF THE PROVISIONS OF CURRENT LAW WHICH ENCOURAGE TAKEOVER ACTIVITY. WE'RE ALL FAMILIAR WITH THE MOST NOTORIOUS CASES. FOR EXAMPLE, CONSIDER U.S. STEEL'S TAKEOVER OF MARATHON OIL IN WHICH, ACCORDING TO SOME PRESS ACCOUNTS, U.S. STEEL PLANNED TO PARTIALLY LIQUIDATE MARATHON IN ORDER TO RECEIVE A STEPPED-UP BASIS IN AN OIL FIELD WITHOUT TRIGGERING THE RECOGNITION OF RECAPTURE ITEMS SUCH AS INVESTMENT TAX CREDIT AND DEPRECIATION. THE RESULTING SAVINGS IN TAXES IS REPORTED TO HAVE BEEN BETWEEN A QUARTER AND A THIRD OF A BILLION DOLLARS.

IN ANOTHER WELL-PUBLICIZED CASE, MOBIL, WISHING TO ACQUIRE A SUBSIDIARY OF ESMARK CORPORATION, COULD HAVE PURCHASED THE STOCK OF THE SUBSIDIARY FROM ESMARK, BUT ESMARK WOULD HAVE BEEN REQUIRED TO RECOGNIZE A SUBSTANTIAL GAIN. BY PURCHASING ESMARK STOCK, THEN HAVING ESMARK DISTRIBUTE THE STOCK OF THE SUBSIDIARY IN REDEMPTION OF MOBIL'S NEWLY-ACQUIRED ESMARK STOCK, MOBIL ENDED UP IN THE SAME POSITION, BUT ESMARK RECOGNIZED NO GAIN.

THE PROVISIONS OF MY BILL ADOPTED BY THE COMMITTEE WILL PREVENT THESE ANOMALOUS EFFECTS. TAKEOVERS MAY OCCUR IN ANY CASE, BUT TAX BENEFITS WILL NOT PROVIDE THE INCENTIVE. ONLY ECONOMICALLY SOUND TAKEOVERS WOULD CONTINUE TO OCCUR. I DEFER TO THE JUDICIARY COMMITTEE TO DETERMINE WHETHER OUR ECONOMY'S LIMITED RESOURCES SHOULD BE DEVOTED TO THIS KIND OF ACTIVITY. NO DOUBT, IN SOME CASES, THESE TRANSACTIONS ARE BENEFICIAL TO ALL CONCERNED -- INCLUDING THE ECONOMY AS A WHOLE. BUT I CONTINUE TO BELIEVE THAT IN MANY OTHER CASES, TAKEOVER ACTIVITY IS DETRIMENTAL TO THE ECONOMY.

I KNOW THAT MANY OF THE WITNESSES WE WILL HEAR FROM WILL ARGUE THAT THE PROVISIONS OF THE BILL GO FAR BEYOND THE QUESTION OF WHETHER THE TAX LAW SHOULD PROVIDE ASSISTANCE TO CORPORATE TAKEOVERS. THEY WILL POINT OUT THAT THE TYPES OF TRANSACTIONS TO WHICH I HAVE REFERRED MAY BE PREVENTED BY LESS SWEEPING LEGISLATION, AND THAT THE FURTHER ADDITIONAL CHANGES IN THE LAW WHICH THE BILL WOULD MAKE ARE UNNECESSARY FOR THIS PURPOSE. I UNDERSTAND THAT THESE ADDITIONAL CHANGES (WHICH ADDRESS THE FUNDAMENTAL ISSUE OF WHETHER THE SUPREME COURT'S HOLDING IN THE GENERAL UTILITIES CASE SHOULD BE ACCEPTED OR REJECTED) REPRESENT ISSUES THAT MOST PROFESSIONAL GROUPS AGREE SHOULD BE ADDRESSED. HOWEVER, IT IS THEIR CONCERN THAT THE BILL DOES NOT ADDRESS ALL ISSUES RELATED TO THE GENERAL UTILITIES DOCTRINE AND, THEREFORE, THOSE PARTS OF THE BILL SHOULD BE DEFERRED UNTIL THE CONGRESS HAS HAD THE OPPORTUNITY TO DEAL WITH ALL ASPECTS OF THE ISSUE. I ALSO UNDERSTAND THAT THESE GROUPS ARE ANXIOUS AND WILLING TO COOPERATE IN ANY SUCH PROJECT.

I WOULD JUST LIKE TO SAY THAT I BELIEVE THE COMMITTEE SHOULD BE FLEXIBLE IN ITS APPROACH. MR. CHAIRMAN, YOUR STAFF, THE JOINT COMMITTEE STAFF, AND MY STAFF ARE WORKING TO DETERMINE IF MORE NARROWLY TARGETED LEGISLATION WILL ACCOMPLISH OUR OBJECTIVES. THAT IS, IF UNDER A MORE NARROW APPROACH, THE SPECIAL BENEFITS OF CURRENT LAW SHICH ENCOURAGE AND EVEN HELP FINANCE TAKEOVERS SUCH AS U.S. STEEL-MARATHON OR MOBIL-ESMARK ARE PURGED FROM THE LAW, I BELIEVE WE WILL HAVE ACCOMPLISHED WHAT WE INTENDED. IN ANY CASE, IT IS MY HOPE THAT THE COMMITTEE, IN CONJUNCTION WITH THE WAYS AND MEANS COMMITTEE AND THE TREASURY DEPARTMENT, WITH THE ABLE ASSISTANCE OF THE JOINT COMMITTEE STAFF, WILL, AS SOON AS POSSIBLE, UNDERTAKE A STUDY TO DETERMINE WHAT STEPS WE SHOULD TAKE IN THE DIRECTION OF FUNDAMENTAL REVISIONS OF CORPORATE TAXATION.

Senator **DANFORTH** [presiding]. This hearing concerns two subjects. One is a provision of the tax bill that this committee reported out the week before last which concerned the tax treatment of corporate acquisitions and liquidations and was originally S. 2687. And the other issue is S. 2224, tax credit for job training.

I would like to say a few words first about S. 2687 and its successor, which is part of the tax bill. The objective of this provision is to revise the provisions of current law which provide special tax benefits to a corporation acquiring other corporations in certain transactions.

In general terms, Mr. Chairman, I am disturbed by the lack of response to the incentives for new investement in productive plant and equipment and research and development which the Congress provided American business almost exactly a year ago. Since then, not only have corporations not moved to modernize as we hoped they would, it is generally agreed that by the end of 1982 there will actually have been less investment in new productive assets and R&D than in 1981.

The question one must ask is: What is business doing? If it is not taking advantage of these incentives to help push our economy into strong recovery, what is it doing?

One thing businesses are taking advantage of is the fact that their outstanding stock is undervalued, compared to the value of their underlying assets, by buying up their own treasury stock. This is the opposite of what we intended with the Economic Recovery Tax Act, which was growth and expansion. Instead, these companies are adopting contraction as their corporate policy. This particular activity is the subject of a bill which I introduced in June, which is not a part of the committee's package.

The second thing corporations are taking advantage of is the fact that their outstanding debt has dropped in value as a result of continuing high interest rates. The law, after the adoption of the Bankruptcy Act of 1980, allows corporations to retire their debt with stock without gain recognition.

Thus, if a corporation issues $600 worth of its stock to retire a $1,000 bond, it recognizes no gain, even though, had it paid $600 in cash to retire the bond, it would have had to recognize $400 of gain, and even though in many cases the original owner of the bond has recognized a $400 loss for tax purposes.

This situation is the subject of another bill I introduced last month which is not included in the committee's package. I believe that these situations are very serious, and I hope that we could hold hearings on both of these bills in the near future.

Another thing corporations are taking advantage of these days is corporate takeover opportunities, and too often they occur because of the incentive that current tax law provides. It is this activity which is the subject of my bill which is included in the committee package.

As with a policy of corporate contraction, takeovers, particularly those which are significantly motivated by tax consideration, contribute virtually nothing to our economic recovery. In fact, it is my view that this type of activity has contributed to the persistence and severity of this recession.

We have all read about dozens of takeover attempts on the part of this country's leading corporations during the past year or so. In the usual case, these transactions tie up hundreds of millions of dollars in investment capital, which not only adds pressure to interest rates but prevents the investment of that capital in productive assets.

I have yet to read about a takeover that promoted one new job. In fact, I am confident that it could be demonstrated that in every case jobs are actually lost. This has a devastating effect on the local economy where the target corporation is located and, on a collective basis, has, I am convinced, contributed significantly to the Nation's economic woes.

This committee does not have the jurisdiction to decide whether mergers and takeovers are bad. The Judiciary Committee, on which Senators Grassley and Baucus as well as Chairman Dole sit, has that power.

But this committee does have the jurisdiction and, I believe, the responsibility to insure that the tax system is neutral with respect to corporate takeovers. It should provide neither special benefits from, nor impediments to, mergers and acquisitions.

But present law in many circumstances does provide tax incentives which may encourage takeovers without regard to whether the transaction presents an opportunity to improve the utilization of productive investment. In such cases, not only does the tax system encourage the transaction, but the effect is the same as if the Treasury Department had helped to finance the takeover.

This bill is designed to remove the most blatant of the provisions of the current law which encourage takeover activity. We are all familiar with the most notorious cases.

For example, consider the United States Steel takeover of Marathon Oil in which, according to some press accounts, United States Steel planned to partially liquidate Marathon in order to receive a stepped-up basis in an oilfield without triggering the recognition or recapture items such as investment tax credit and depreciation. The resulting savings in taxes is reported to have been between a quarter and a third of a billion dollars.

In another well-publicized case, Mobil, wishing to acquire a subsidiary of Esmark Corp., could have purchased the stock of the subsidiary from Esmark, but Esmark would have been required to recognize a substantial gain. By purchasing Esmark stock, then having Esmark distribute the stock to the subsidiary in redemption of Mobil's newly acquired Esmark stock, Mobil ended up in the same position, but Esmark recognized no gain.

The provisions of this bill adopted by the committee will prevent these anomalous effects. Takeovers may occur in any case, but tax benefits will not provide the incentive. Only economically sound takeovers would continue to occur.

I defer to the Judiciary Committee to determine whether our economy's limited resources should be devoted to this kind of activity. No doubt, in some cases these transactions are beneficial to all concerned—including the economy as a whole. But I continue to believe that in many other cases takeover activity is detrimental to the economy.

I know that many of the witnesses we hear from will argue that the provisions of the bill go far beyond the question of whether the tax law should provide assistance to corporate takeovers. They will point out that the types of transactions to which I have referred may be prevented by less sweeping legislation and that the further additional changes in the law which the bill would make are unnecessary for this purpose.

I understand that these additional changes, which address the fundamental issue of whether the Supreme Court's holding in the *General Utilities* case should be accepted or rejected, represent issues that most professionals agree should be addressed.

However, it is their concern that the bill does not address all issues related to the *General Utilities* doctrine and, therefore, those parts of the bill should be deferred until the Congress has had the opportunity to deal with all aspects of the issue. I also understand that these groups are anxious and willing to cooperate in any such project.

I would like to say that I believe the committee should be flexible in its approach. The staff of the committee, the joint committee staff and my staff, are working to determine if more narrowly targeted legislation will accomplish our objectives. That is, if under a more narrow approach the special benefits of current law which encourage and even help finance takeovers such as United States Steel-Marathon, or Mobil-Esmark are purged from the law, I believe we will have accomplished what we intended.

In any case, it is my hope that the committee, in conjunction with the Ways and Means Committee and the Treasury Department, with the able assistance of the joint committee staff, will, as soon as possible, undertake a study to determine what steps we should take in the direction of fundamental revisions of corporate taxation.

Senator Chafee.

Senator **Chafee**. Thank you very much, Mr. Chairman. I want to commend you for taking the lead in this legislation. I believe it is important. I believe that some of the takeovers we have seen over the past year have been not directed toward increased productivity or the general welfare of the Nation, by a long shot, but have resulted in reduced employment, as you mention, and have caused considerable grief in the communities where the headquarters of some of the corporations that have been taken over were located previously.

It is not my objective to prevent takeovers. That is fine if one company wants to take over another. But I do not think that the U.S. Government through its tax policy should be subsidizing these takeovers. At the same time, I think, as you pointed out in your statement, there are occasions where this legislation has gone too far and has swept up acquisitions that this was not directed toward.

So we look forward to the testimony today. And we do hope that the witnesses will have some constructive alternatives for us. It does not do us much good for the witnesses to lament the situation in which we, in our attempt to take care of the problems as outlined by Senator Danforth, may have affected so-called innocent parties. If that is so, we want to know how to rectify that. So we would hope that the witnesses would have some constructive proposals to assist us in our efforts to make this the type of legislation that we all seek.

Thank you, Mr. Chairman.

Senator **Danforth**. Senator Dole.

The **Chairman**. I have no statement.

Senator **Danforth**. Well, we are happy to have with us as our first witness our colleague, Senator Metzenbaum.

STATEMENT OF HON. HOWARD M. METZENBAUM, A U.S. SENATOR FROM THE STATE OF OHIO

Senator **Metzenbaum**. Mr. Chairman and members of the committee, thank you for giving me the opportunity to testify on behalf of my bill S. 2547, and S. 2687, the bill introduced by Senator Danforth.

I believe that the chairman and the members of this committee should be proud of the tax bill that was reported to the Senate floor Tuesday. It is a fact that I disagree with some of the specifics of that legislation. But I believe that the committee's action indicates the concern that it has about some of the tax loopholes that exist in our laws. The bill that came out of committee represents a serious and important effort to instill a greater degree of equity and fairness into our tax laws.

I want especially to state my support for the bill's provisions closing tax loopholes that permit large corporations involved in mergers and acquisitions to avoid paying substantial amounts of tax, the subject of today's hearings.

As we have watched corporate giants merge with dizzying speed in recent months, one fact has become abundantly clear: the corporations and their high-priced lawyers are making a mockery of our tax laws to legally escape paying hundreds of millions, and perhaps billions, of dollars in taxes.

As the acting chairman pointed out, United States Steel bought Marathon Oil; Atlantic-Richfield bought Anaconda; American Express bought Shearson Loeb Rhoades; Gulf acquired Cities Service; and the merger mania goes on and on.

Why? Because our current tax system promotes and subsidizes these and dozens of other corporate tax takeovers.

Each merger ties up precious capital. And when we are seeking to find the necessary funding to bring down interest rates, we find corporations using their funds—almost an unlimited amount of funds, as a matter of fact—for the purpose of financing takeovers of other corporations. As a result, those funds are not available in the economic mainstream.

These mergers reduce the funds available for job-creating small-business expansion and housing production. And in each of these mergers at a time when there is so much concern about the shortage of money, the companies are able to go into the banking and money markets and find whatever funds they need. This results in billions upon billions being committed for the purpose of takeovers.

Now, you would think that the American people or the U.S. Government would get something out of all of this. But the fact is that few of the mergers have been beneficial to the people of this country. They do not improve management. They do not improve efficiency. They do not improve productivity. They do not create new jobs. All they do is provide the companies involved with lucrative and unearned tax breaks.

Now, let me say as one who came out of the business world before I came into the Senate, that I do not find fault with the corporate executives that take these actions, or the lawyers who represent them. That is their responsibility to their corporate stockholders. But I think our responsibility to the people in fashioning the tax laws is of a totally different nature. And it is in this respect that I think these bills zero in on the problem that does exist.

At a time when the Reagan administration is proposing cuts, and making cuts, in social security, child nutrition, student loans, medicaid, and other human service programs, I do not believe we can or should subsidize economically destructive mergers.

I heard my good friend from Rhode Island say a few moments ago, if companies want to merge, that is fine. Let me say for myself, I do not accept that concept. I believe that the mergers ought to be economically justified. I believe that they ought not to violate our antitrust laws. And I believe that they ought to have some means of adding to the competitive aspects of the free enterprise system, not diminishing that competitive involvement.

Unfortunately, we have today an administration administering the antitrust laws which has done little, and has publicly indicated it expects to do little, to deter corporate mergers and even less to enforce existing antitrust laws.

Yet even the Assistant Secretary of the Treasury said in recent testimony before this committee that, "Tax-motivated mergers serve no economic purposes, but lead to a greater concentration of economic power."

Now, the bill that I have before you was introduced last May. It is similar to Senator Danforth's bill. And it is similar in content and purpose to H.R. 6295. The House Ways and Means Committee has already held hearings on H.R. 6295. And these bills, and the proposed law as it is on the Senate floor, will eliminate two loopholes that promote tax-motivated mergers.

The first of these deals with a provision of the Internal Revenue Code which presently allows a firm acquiring another company to avoid "recapture" by the Treasury of excessive depreciation deductions and investment tax credits previously taken by the target company.

The United States Steel-Marathon Oil merger gives a striking example of how the recapture loophole works. Over the years, one of Marathon's most valuable assets has been the rich Yates oil field. Marathon has, like other oil companies, used a variety of Internal Revenue Code provisions to reduce its tax burden—chiefly investment tax credits, accelerated depreciation, and intangible drilling cost deductions.

Normally, the acquisition of Marathon by United States Steel would trigger the Code's recapture provision, a method devised by Congress to enable the Treasury to recover all or a portion of the excess depreciation on an asset at the time of its sale. But the loophole in question allows the new United States Steel-Marathon entity to avoid recapture.

This was accomplished by United States Steel's purchasing the Yates field from Marathon. Then United States Steel was able to increase the depreciation deductions in the oil field since the property's present value is greater and therefore the tax basis is greater. By filing a single tax return for the merged companies, known as a consolidated return, United States Steel can defer recapture of Marathon's excess depreciation and totally avoid recapture of Marathon's investment tax credits.

This procedure, according to the United States Steel prospectus on the merger, will save United States Steel $400 million in taxes in the first year alone. And that is based upon their own representation made in their own prospectus.

Now, that may be good for United States Steel and for other acquiring companies. But, it certainly is not good for other businesses and individual taxpayers who must ultimately make up the revenue loss and one way or the other pick up the tab for that $400 million which will not flow to the Treasury.

The second loophole to which my bill is addressed involves the tax treatment of capital gains realized by a firm which redeems its stock in return for depreciated assets.

What does this mean? The classic case study is provided, as indicated by the acting chairman, by Mobil Oil's acquisitions of Esmark's oil subsidiary, Vickers Petroleum Energy Corp. Here is how the deal worked. Pursuant to an understanding made in advance, Mobil bought enough shares of Esmark to equal the agreed purchase price. Esmark then turned around and redeemed its shares from Mobil in exchange for the stock of Vickers.

Congress has recognized the potential in such transactions for abuse. In 1969 Congress enacted a provision which requires a corporation to pay tax on the profit earned when it distributes appreciated property in order to redeem stock.

But for whatever reason, Congress at the same time enacted seven exceptions to this general rule. One of these exceptions allows the transfer to be tax free if the appreciated property is the stock of a subsidiary, 50 percent or more owned by the redeeming corporation. This exception offers corporations an oportunity to continue the very sheltering activity that Congress intended to halt.

Robert Wilkins, a partner with Peat, Marwick, Mitchell & Co., described the transaction this way in a Forbes magazine interview:

> After the deal for the oil properties has already been struck and the price agreed upon, Esmark said, "Look, Mobil, you go out and tender for whatever portion of my stock the subsidiary is worth. Then as soon as you get the stock, we will turn over the oil operation to you in exchange for the stock."

The quote is from a partner in one of the Nation's most well known accounting firms.

Now, that is a pretty neat and a pretty tidy arrangement. In this case, it was worth an estimated $100 million in tax savings to Esmark.

In a transaction involving Dome Petroleum and Conoco Oil Co., Dome saved an estimated $250 million through the same procedure. IU International, Inc. and American Home Products, each used a similar tactic to escape taxes in deals involving Canadian Utilities, Ltd. and the Sherwood Medical Group, respectively.

Every time one of these procedures occurs, somebody else has to be called upon to pick up the lost revenue. And if there were some good logical reason—if somebody could say, well, this is going to cause production, that this is going to cause more jobs, that this is going to help the economy in some way, that this is going to bring down oil prices—so be it. At least that would be something positive.

But to the best of my knowledge, and to the best of the knowledge of those scholars who have written on the subject, these activities contribute very little to the economy as a whole or to the Nation.

Mr. Chairman, laws like these give corporations an incentive to merge. The current merger madness is the price we pay for them. Rather than seeking mergers to improve efficiency, to better serve consumers, to improve productivity, or to create jobs, corporations are literally looking for tax shelters.

What an unbelievable waste of investment capital. Those who are the strong advocates of supply-side economics say that if business has more money, they will put more money into the tools of production and therefore cause more jobs to be created. Instead laws permit companies to use scarce funds for the purpose of acquiring other corporations and, in too many instances, the Federal Government subsidizes the acquisition itself. What a drain on the Federal budget that is starved for revenue.

We have already seen that this administration cares little about enforcing antitrust laws designed to prevent anticompetitive mergers. And I lay that responsibility directly at the doorstep of Mr. Baxter, who made it very clear in appearing before the Judiciary

Committee that he does not intend to follow the decisions of the Supreme Court that have been handed down over a period of many years.

But with respect to the tax aspects of it—it is obvious that the the whole question of antitrust enforcement is in a totally different committee—I believe that this committee has done well in sending to the floor the language in the proposed tax bill relating to mergers.

We at least should be eliminating some of the laws that are destructive to the free enterprise system. The chairman of this committee and you, Senator Danforth, are to be commended for taking the initiative in the committee to close this particular loophole.

I intend to work with you on the Senate floor to see to it that it is not emasculated by amendments.

Senator **Danforth**. Senator Metzenbaum, thank you very much. We appreciate your being here.

In my view, it is not just the economic facts—the misallocation of resources, the loss of tax revenue—that is involved, but it is also what happens to a community. I think that it is well known that for a community to have a corporate headquarters within its boundaries is a tremendous community asset. It provides leadership for a host of activities: The United Fund, the symphony, the hospitals, all kinds of community projects which receive an added boost by having a corporate headquarters there to support it and provide that kind of leadership for it.

I have seen what happens, the loss that is suffered by a community when what was a corporate headquarters becomes the division headquarters. And it seems to me that at the very least, the tax laws should be neutral and that we should not, in effect, be subsidizing in the Internal Revenue Code this kind of activity which, in my opinion, is deleterious to the health of the community.

I wonder if you have noticed also in your State the effect within a community on the loss of a corporate headquarters?

Senator **Metzenbaum**. I could not agree with the acting chairman more. I certainly have. Ohio has been a State which has had more corporate headquarters, in Cleveland specifically, than any other city between Chicago and New York.

And we have seen, as the merger madness has moved forward, how so many of our local companies have been gobbled up and, as a consequence, that community involvement, participation, and ability to contribute, just does not exist thereafter.

And I might say, not including my own businesses in the category of the corporate giants, but having headed a company that was itself merged into a much larger corporation, ITT, it is a reality of life that the contributions which we as a company were able to participate in and to make no longer were our responsibility. Our participation became a matter of petitioning for some funding for local charitable contributions and for other kinds of involvement.

I have experienced it individually, having been head of a company that sold out to a much larger corporation, and I have seen it with much larger corporations in the Cleveland, Ohio, community that have been sold to other companies. I have seen where some, in Youngstown, have literally been milked by the acquiring company and then eventually were closed up. This in a community such as

Youngstown without any opportunity for further employment in the steel industry.

Senator DANFORTH. Thank you.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Thank you, Senator, for your statement.

Without putting you on the spot, you mention in your opening paragraphs of your statement that you disagreed with some aspects of the tax bill. This is peripheral to this discussion, but I am curious just to get a lead, as we proceed with this tax bill, what are some of the areas you found disagreement with?

Senator METZENBAUM. I find some difficulty with the doubling of the cigarette tax, the doubling of the telephone tax, and of the reduction of the right to deduct medical expenses and casualty losses.

I have a very great difficulty with the medicare aspects of the bill. And I have difficulty with some other of the details having to do with some of the spending programs.

My support for your legislation is more particularly directed at that which people call a tax increase, and I am not willing to charge this committee with that. I consider it to be a closing of tax loopholes except in the areas that I have spoken to. And I think there is one other that slips me at the moment.

The CHAIRMAN. I think it is Airline tickets.

Senator METZENBAUM. Airline tickets.

The CHAIRMAN. That is not new.

Senator METZENBAUM. Yes. But I have indicated to the chairman previously that I would like to try to be helpful to this committee in securing passage of the bill. But it is a fact that some parts of it create very great difficulties for me as well as some other Members of the Senate who I think would be disposed to be supportive of about 90 percent of the tax part, maybe not in agreement with respect to about 10 percent. But it is on the other side of the coin that so much difficulty arises.

Senator CHAFEE. I see.

Senator METZENBAUM. That is a rather lengthy answer.

Senator CHAFEE. No, no. I appreciate that that was not what you came here to testify on. But as we move forward with the legislation, it is just as helpful to me to get a feel of how the different Members regard it. And you specifically happened to mention it. So I just wanted to explore that with you a little bit. Thank you.

In praising your statement, it does not mean I agree with everything in it, such as the suggestion that this administration is not interested in antitrust activities and the suggestion that the administration is proposing cuts in social security. But we do not have to spend time on those today.

Senator METZENBAUM. We will not have to debate that. There will be plenty of opportunities to debate such matters in the next forum.

Senator CHAFEE. Thank you. Thank you for coming.

Senator DANFORTH. Senator Dole.

The CHAIRMAN. Well, thank you very much.

First I want to thank Senator Danforth for chairing these hearings, and I want to thank Senator Byrd for insisting we have these hearings before we proceed on the Senate floor with this provision in our bill. And we will hear from Treasury witnesses, who will indicate that they believe we are on the right track.

There have been hearings on the House side, but as Senator Byrd correctly noted during our discussion, there had been no Senate hearings.

And we believe that the provision perhaps should be modified to some extent. But I would point out, as I try to point out at every opportunity, that we do not have much to play with in the bill on the Senate floor. That is one problem. It is not like a normal tax bill; we run into the reconciliation restraints.

We may have a cushion of $400 to $500 million in the bill. Otherwise, we fall below our targets; then we have to go back and start trying to pick up more revenue from people already covered by the bill because we cannot offer nongermane amendments, as the Senator from Ohio knows.

So we are certainly going to listen carefully to the witnesses who disagree with this provision. I would only say to Senator Metzenbaum I appreciate very much your willingness to look at our work objectively, as you have done. We believe even in the areas that you mention, that we can justify the increases.

The telephone tax, I just happened to check the Maryland telephone bill with the State and local tax of $3.51 on a $34 bill. The Federal tax is 23 cents. We would increase that to 46 cents.

The cigarette tax, if you smoke 200 packs a year, is $16 more. The airline ticket tax is going back to where it was, to 8 percent. But those are areas where there probably was not much in the way of tax policy involved, but which we had to address trying to reach the $98.3 billion mark. And it was difficult without coming in with an energy tax and without affecting the third year.

But I do appreciate not only what you have said here but our private conversations about our efforts.

Senator Metzenbaum. I thank the chairman.

Senator Danforth. Senator Byrd.

Senator Byrd. Thank you.

I am neither for nor against the proposal as it was included in the tax package. I did feel, as Senator Dole stated, that most of us really did not have any real feeling for the ramifications of this proposal, and we ought to have a hearing on it. And I appreciate Senator Dole and Senator Danforth holding this hearing.

I have no questions.

Senator Danforth. Senator Metzenbaum, thank you very much for being with us.

Senator Metzenbaum. Thank you.

[The prepared statement of Senator Metzenbaum follows:]

TESTIMONY OF SENATOR HOWARD M. METZENBAUM

Mr. Chairman, thank you for giving me the opportunity to testify on behalf of S. 2547 and S. 2689.

I believe that the Chairman and the members of this Committee should be proud of the tax bill that was reported to the Senate floor Tuesday. Although I may disagree with some of the specifics of that legislation, I believe that it represents a serious and important effort to instill a greater degree of equity and fairness into our tax laws. I want to especially state my support for the bill's provisions closing tax loopholes that permit large corporations involved in mergers and acquisitions, to avoid paying substantial amounts of tax -- the subject of today's hearing.

As we have watched corporate giants annex one another with dizzying speed in recent months, one fact has become abundantly clear: the corporations and their high-priced lawyers are making a mockery of our tax laws to legally escape paying hundreds of millions, and perhaps, billions, of dollars in taxes.

U.S. Steel bought Marathon Oil; Atlantic Richfield bought Anaconda; American Express bought Shearson Loeb Rhodes; Gulf acquired Cities Service; and the merger mania goes on and on.

Why? Because our current tax system promotes and subsidizes these and dozens of other corporate takeovers. Each merger ties up precious capital, helping to keep interest rates high and reducing the funds available for job-creating small business expansion and housing production.

You would think we would get something out of all this. But the fact is that few of these mergers are beneficial. They do not improve management, efficiency or productivity. They do not create new jobs. All they do is provide the companies involved with lucrative and unearned tax breaks.

At a time when the Reagan Administration is proposing cuts in Social Security, child nutrition, student loans, Medicaid and other human service programs, I do not believe we can or should subsidize economically-destructive mergers.

It is no secret that we have today an Administration which has done little to deter corporate mergers and even less to enforce existing antitrust laws. Yet, even the Assistant Secretary of the Treasury said in recent testimony before this Committee that, "tax-motivated mergers...serve no economic purposes, but...lead to a greater concentration of economic power."

Mr. Chairman, I couldn't agree more.

Last May, I introduced S. 2547, a bill almost identical to Senator Danforth's bill, which is also similar in content and purpose to H.R. 6295. The House Ways and Means Committee has already held hearings on H.R. 6295. These bills will eliminate two loopholes that promote tax-motivated mergers.

The first of these deals with a provision of the Internal Revenue Code which presently allows a firm acquiring another company to avoid "recapture" by the Treasury of excessive depreciation deductions and investment tax credits previously taken by the target company.

The U.S. Steel-Marathon Oil merger gives a striking example of how the recapture loophole works.

Over the years, one of Marathon's most valuable assets has been the rich Yates Oilfield. Marathon has, like other oil companies, used a variety of Internal Revenue Code provisions to reduce its tax burden, chiefly investment tax credits, accelerated depreciation and intangible drilling cost deductions.

Normally, the acquisition of Marathon by U.S. Steel would trigger the Code's recapture provision, a method devised by Congress to enable the Treasury to recover all or a portion of the excess depreciation taken on an asset at the time of its sale.

But the loophole in question allows the new U.S. Steel-Marathon entity to avoid recapture. This was accomplished by U.S. Steel purchasing the Yates Field from Marathon. U.S. Steel was then able to increase the depreciation deductions in the oil field since the property's present value is greater, and therefore the tax basis is greater. By filing a single tax return for the merged companies, known as a consolidated return, U.S. Steel can defer recapture of Marathon's excess depreciation and totally avoid recapture of Marathon's investment tax credits.

This procedure, according to the U.S. Steel prospectus on the merger, would save $400 million in taxes in the first year alone!

That may be good for U.S. Steel and for other acquiring companies, but it most certainly is not good for other business and individual taxpayers who must ultimately make up the revenue given away via tax provisions like this one.

The second loophole to which my bill is addressed, involves the tax treatment of capital gains realized by a firm which redeems its stock in exchange for appreciated assets.

What does that mean? The classic case study is provided by Mobil Oil's acquision of Esmark's oil subsidy, Vickers Petroleum Energy Corporation.

Here's how the deal worked:

Pursuant to an understanding made in advance, Mobil bought enough shares of Esmark to equal the agreed purchase price. Esmark then turned around and redeemed its shares from Mobil in exchange for the stock of Vickers.

Congress has recognized the potential in such transactions for abuse. In 1969, Congress enacted a provision which requires a corporation to pay tax on the profit earned when it distributes appreciated property in order to redeem stock.

But for whatever reason, Congress at the same time enacted seven exceptions to this general rule. One of these exceptions allows the transfer to be tax-free if the appreciated property is the stock of a subsidiary, 50 percent-or-more owned by the redeeming corporation. This exception offers corporations an opportunity to continue the very sheltering activity that Congress intended to halt.

Robert Wilkins, a partner with Peat, Marwick, Mitchell and Co., described the transaction this way in a Forbes Magazine interview:

> "After the deal for the oil properties has already been struck and the price agreed upon, Esmark said, 'Look Mobil, you go out and tender for whatever portion of my stock the subsidiary is worth. Then, as soon as you get the stock, we will turn over the oil operation to you in exchange for the stock.'"

A pretty neat and tidy arrangement. In this case, it was worth an estimated $100 million in tax savings to Esmark. In the transaction involving Dome Petroleum and Conoco Oil Company, Dome saved an estimated $250 million through the same procedure. IU International, Inc. and American Home Products each used a similar tactic to escape taxes in deals involving Canadian Utilities, LTD., and the Sherwood Medical Group respectively.

Mr. Chairman, laws like these give corporations an incentive to merge. The current merger madness is the price we pay for them. Rather than seeking mergers to improve efficiency, to better serve consumers, to improve productivity or to create jobs, corporations ae literally searching for tax shelters. What a waste of investment capital! And what a drain on a Federal budget that is starved for revenue.

We have already seen that this Administration cares little about enforcing our antitrust laws designed to prevent anti-competitive mergers. We should at least eliminate some of the laws that are destructive to our free enterprise system.

I commend the Chairman of this Committee and Senator Danforth for taking the initiative in the Committee to close these loopholes. And I intend to work with them on the floor of the Senate to preserve these provisions in the tax bill.

Senator **Danforth**. The next witness is David Glickman, deputy assistant secretary for tax policy, Department of the Treasury.

STATEMENT OF DAVID GLICKMAN, DEPUTY ASSISTANT FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. **Glickman**. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the views of the Treasury Department on S. 2687 and S. 2547 relating to corporate acquisitions. A bill similar to S. 2687, H.R. 6725, has been referred by the Subcommittee on Select Revenue Measures to the House Committee on Ways and Means with the recommendation that it be approved.

S. 2687 would change the corporate tax provisions of subchapter C of the Internal Revenue Code in three essential respects. First, it would provide new rules governing the taxation of distributions from a corporation to its shareholder in redemption of stock, including a distribution which under present law qualifies as what is called a partial liquidation.

Second, it would repeal the provision of the Code which treats corporate purchases of stock followed by a liquidation as a purchase of assets, replacing it with a new provision designed to achieve the same results in a simpler, more efficient, and more effective manner.

Finally, it would eliminate the ability of a corporate purchaser to selectively treat an acquisition in part as an asset purchase with an attendant step-up in basis and in part as a stock purchase with an attendant avoidance of recapture and other tax detriments.

S. 2547 contains similar rules to those in S. 2687 with respect only to distributions.

The Treasury Department supports S. 2687. This bill, in our judgment, would curb certain specific abuses which have recently emerged and would prevent other abusive transactions in the future by curing certain inconsistencies in the Code which have been used by taxpayers to their benefit. The elimination of these inconsistencies, we believe, is a desirable development in the tax law. While we also support generally S. 2547, we prefer the more comprehensive solution of S. 2687.

Mr. Chairman, the remainder of my testimony is very detailed and goes into the specifics of the bill and how the various provisions interrelate. I would like to submit the entire statement for the record, and more or less paraphrase what the bill does.

Senator DANFORTH. Fine. Your entire statement and the entire statement of all witnesses will be included in the record in full.

[The prepared statement of Mr. Glickman follows:]

For Release Upon Delivery
Expected at 9:30 a.m. EDT
July 15, 1982

STATEMENT OF
DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
BEFORE THE
SENATE COMMITTEE ON FINANCE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you to present the views of the Treasury Department on S. 2224.

This bill would provide taxpayers who make charitable contributions to qualified tax-exempt job training organizations with a tax credit equal to 20 percent of such contributions. The Treasury Department opposes S. 2224.

Description of S. 2224

~~S. 2224~~ The bill would grant taxpayers a tax credit equal to 20 percent of their charitable contributions to certain qualified tax exempt organizations. To qualify, these organizations would need to be certified by the Labor Department as providing job training solely to handicapped individuals, economically disadvantaged individuals, and displaced workers. Credits for the contributions would be permitted in addition to the deduction for the full amount of the charitable contribution. The credit would be available for all qualifying contributions made in taxable years beginning after December 31, 1981.

A contributor would be permitted up to $250,000 in tax credits per year for qualifying contributions. Subject to this annual limitation, the credit could be used to offset 100 percent of the contributor's income tax liability ~~(as reduced by certain other tax credits)~~ for the taxable year in which the credit is used. Credits that are not used in the year of contribution could be carried forward 15 years and carried back 3 years. The carryback period would include taxable years prior to the effective date of the provision.

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Discussion

certainly Mr. Chairman,

The Administration agrees/that Federal assistance is needed in training disadvantaged individuals for new jobs. Thus, the Administration supports S. 2036, the Training for Jobs Act of 1982, which was unanimously passed by the Senate on July 1, 1982. Under this bill, the Labor Department will allocate Federal resources to the 50 states in the form of job training grants. State Governors will have broad supervisory authority over local programs, which will be designed and administered by Private Industry Councils consisting of a majority of private business sector members along with representatives of education, local government, organized labor, community based organizations and others. These Private Industry Councils will determine the types of classroom job training programs and on-the-job training programs that fit each locality's specific needs and how Federal funds can best be used to encourage other members of the private sector to participate in these job training programs. While training eligibility will concentrate on two targeted groups -- economically disadvantaged young adults and economically disadvantaged families with dependent children -- program operators will be able to use a portion of their funds for persons with other labor market disadvantages. This will include displaced and migrant workers, handicapped individuals, jobless veterans, and older individuals. We are advised that a portion of the job training programs to be funded by these state grants will, in fact, be conducted by the same tax-exempt organizations which S. 2224 would assist.

also In evaluating S. 2224, it is also significant to note that this Committee has just approved a 3-year extension of the targeted jobs tax credit. The targeted jobs tax credit provides tax credits to employers based upon wages they pay to employees who are members of certain targeted groups. Although we have certain tax policy concerns regarding the targeted jobs tax credit, the Administration supported an extension of this program.

The Treasury Department believes that if tax credits are to be used to provide Federal assistance to promote jobs for disadvantaged individuals, the approach of the targeted jobs tax credit generally is preferable to the approach of S. 2224. Though S. 2224 will assist in providing job training, there is no assurance that jobs will be available. Indeed, the credit can be taken by taxpayers with no jobs to offer. In contrast, the targeted jobs tax credit is granted to employers who supply actual jobs, many of which will provide some form of on-the-job training. S. 2224 would also make possible a "double credit" with respect to a worker who is trained with contributed funds that generate a credit under S. 2224 and whose subsequent wages also generate a targeted jobs tax credit.

Furthermore, although we recognize the importance of job training for disadvantaged individuals, we question whether contributions to provide funds to charitable entities for this purpose should be granted more favorable treatment than contributions to charitable entities for other worthwhile causes. If a special tax credit were provided for charitable contributions in this case, it would be very difficult to deny similar tax credits for contributions to organizations that conduct research concerning crippling diseases, birth defects, ~~or~~ cancer, ~~provide food and shelter to needy children, or undertake other worthy projects.~~ etcetera.

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~~In addition to the basic policy concerns just discussed, I would like to comment on two of the more important technical aspects of the bill. First, S. 2224 would grant tax credits for contributions made in taxable years beginning after December 31, 1981. Thus, the bill would give a windfall to taxpayers who make qualifying contributions after the effective date (January 1, 1982 for calendar year taxpayers), but prior to the date of enactment. Since this bill is intended to provide incentives for job training support, it should not reward taxpayers who have previously made contributions.~~

~~Second, S. 2224 should require that the amount of the charitable contribution deduction be reduced by the amount of the credit. A taxpayer should not be allowed a deduction for that portion of an expenditure which has been paid for by the Federal government in the form of a tax credit. For example, the targeted jobs credit requires employers to reduce the amount of the deduction for wages paid by the amount of the credit.~~

Finally, the tax credits provided by S. 2224 will add complexity to the Federal tax law and will decrease Federal revenues. The Treasury Department estimates that the revenue losses would be $51 million in 1983, $41 million in 1984, $48 million in 1985, $58 million in 1986 and $68 million in 1987. This revenue loss is particularly troublesome at a time when concerted efforts are being made to reduce the Federal deficit.

Conclusion

For these reasons, the Treasury Department opposes S. 2224.

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STATEMENT OF
DAVID G. GLICKMAN
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to have the opportunity to present the views of the Treasury Department on S. 2687 and S. 2547, relating to corporate acquisitions. A bill similar to S. 2687, H.R. 6725, has been referred by the Subcommittee on Select Revenue Measures to the House Committee on Ways and Means with the recommendation that it be approved.

S. 2687 would change the corporate tax provisions of Subchapter C of the Internal Revenue Code of 1954, ~~as amended (the "Code")~~ in essentially three respects. First, it would provide new rules governing the taxation of distributions from a corporation to its shareholders in redemption of stock, including distributions which under present law qualify as partial liquidations. Second, it would repeal the provision of the Code ~~(section 334(b)(2))~~ which treats a corporation's purchase of stock followed by a liquidation as a purchase of assets, replacing it with a new provision ~~(section 338)~~ designed to achieve the same results in a

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simpler and more effective manner. Finally, it would eliminate the ability of corporate purchasers to selectively treat an acquisition in part as a purchase of assets (with attendant basis step up) and in part as a purchase of stock (with attendant avoidance of recapture and other tax detriments). S. 2547 contains ~~rules~~ similar rules to those of S. 2687 with respect to distributions ~~(the first of the three areas covered by S. 2687), but does not contain the remainder of the provisions~~.

The Treasury Department supports S. 2687. This bill in our judgment would curb certain specific abuses which have recently emerged, and would prevent other abusive transactions in the future, by curing certain inconsistencies in the Code which have been used by taxpayers to their benefit. The elimination of these inconsistencies, we believe, is a desirable development in the tax laws. While we also support generally ~~the provisions of~~ S. 2547, we prefer the more comprehensive solution of S. 2687. ①

I will now proceed to discuss the bills in detail.

I. Distributions

a. Generally

Title I of S. 2687 and the provisions of S. 2547 change certain rules of present law relating to the distribution of property from a corporation to its shareholders. At the corporate level, the bills remove certain of the exceptions contained in section 311(d)(2) to the general rule of section 311(d)(1) that a corporation recognizes gain on the distribution of appreciated property in redemption of stock. Similarly, the bills repeal the exemption from gain recognition to the distributing corporation, now contained in section 336, for distributions defined as partial liquidations.

At the shareholder level, the bills repeal the rule of section 346(a)(2), which provides for sale or exchange treatment in the case of a partial liquidation distribution constituting a corporate contraction. Such a distribution will now be treated as a dividend or an exchange event to the shareholder based upon the rules of section 302, relating to reduction of shareholder interest. Distributions of certain active businesses with a 5-year history, presently accorded sale or exchange treatment under section 346(b), will continue to be an exchange event to noncorporate shareholders (or to all shareholders under S. 2547), without regard to whether the distribution results in a meaningful reduction of the distributee's interest. Finally, S. 2687 accords the Treasury broad authority to prescribe such regulations as may be necessary to ensure that the repeal of the partial liquidation rules may not be circumvented by certain avoidance techniques.

b. Section 311(d) -- Distributions by a corporation in redemption of stock

As a general rule, section 311(d)(1) of the Code provides that a corporation recognizes gain when it distributes to a shareholder appreciated property in redemption of stock. Certain exceptions to this rule are provided in section 311(d)(2). Section 102 of S. 2687 and section 2 of S. 2547 would repeal certain of these exceptions, specifically section 311(d)(2)(A), which insulates distributions in complete redemption of a 10-percent shareholder; section 311(d)(2)(B), which excepts distributions of stock or debt of certain subsidiaries; section 311(d)(2)(C), which excepts distributions of stock or securities made pursuant to an antitrust decree; and (in S. 2687) section 311(d)(2)(G), which insulates stock distributions made to effectuate the terms of the Bank Holding Company Act.

The Treasury Department strongly supports repealing these exceptions. In this connection, a few words of history may be helpful.

Section 311(d), which orginated in this Committee, was added to the Code by the Tax Reform Act of 1969. As reported by this Committee, the bill contained none of the exceptions presently provided in section 311(d)(2). Rather, the Committee believed that a corporation which redeems stock with appreciated property has "disposed of [such] property for a corporate purpose to much the same effect as if the property had been sold and the stock had been redeemed with the proceeds of the sale." S. Rep. No. 91-552, 91st Cong., 1st Sess. 279 (1969). Since the latter transaction generates taxable gain, this Committee believed that the former should also.

It has been argued that section 311(d) was designed only to prevent insurance companies from buying back their own stock with investment assets, and was never intended to apply to the distribution of business assets to historic shareholders. While the Finance Committee Report cites as an example of an abusive transaction the insurance company case, the Report further states, "The Committee does not believe that a corporation should be permitted to avoid tax on any appreciated property (investments, inventory, or business property) by disposing of the property in this manner." S. Rep. No. 91-552, 91st Cong. 1st Sess. 279 (emphasis added).

The various exceptions to the general rule were added by the Conference Committee. However, in making these exceptions, the Committee was unsure as to their propriety, requesting further staff analysis of new section 311(d) to determine whether any tax avoidance possibilities remained. Recent transactions in which buyers have purchased blocks of a corporation's stock which they subsequently exchanged for assets of the corporation, the latter claiming nonrecognition on the transaction, have brought into focus the tax avoidance possibilities which these exceptions allow.

The Treasury Department believes that repealing these exceptions is desirable. We readily acknowledge that these bills go beyond the case involving the purchase followed by a redemption. We believe that under existing law, the Internal Revenue Service has the authority to recharacterize certain of these transactions as asset sales by the corporation -- with attendant recognition of gain -- and that such recharacterization would be sustained by the courts. However, these abusive cases are merely symptomatic of the broader issue. As this Committee recognized in 1969, any nonliquidating distribution of appreciated property in exchange for stock carries with it the incidents of a sale. The IRS can handle the abusive cases. Legislation is necessary to cure the defect in the statute.

c. Partial liquidations

(1) Effect on distributing corporation

Under present law (section 336 of the Code), a corporation recognizes no gain or loss on the distribution of property to shareholders in exchange for stock in a transaction defined as a partial liquidation under section 346. We believe that the issue concerning the propriety of this rule is the same as that pertaining to the exceptions to the general rule of section 311(d)(1). In both cases, a corporation is taxed when it sells property to third parties and distributes the proceeds in redemption of its stock. Again, in both cases, no tax is exacted when the distribution is made directly to the shareholder. Indeed, in some cases, distributions falling within the exceptions provided in section 311(d)(2) can be structured as partial liquidations to achieve the same results. As we indicated in the section 311(d) context, a corporation distributing property to a shareholder in exchange for stock should be treated as if it had sold the property. Parallel treatment is required in the partial liquidation context.

Further, the general structure of Subchapter C of the Code reflects a policy that corporate level gain should be excused (if at all) only in the context of a complete liquidation. Under section 337 of the Code, a corporation generally does not recognize gain or loss upon the sale of assets incident to a complete liquidation. Present law does not embody this policy in the partial liquidation and redemption cases. Rather, present law creates a disparity depending on the form of the transaction, exempting from tax only those sales cast in the partial liquidation or redemption mold. Such disparity creates tensions and inconsistencies in the tax system that can be used by taxpayers to their benefit, as the recent abusive transactions bear witness. The solution, we believe, is not to put a bandage on the specific abusive cases. The solution is to cure the defect that allows such abusive cases, and others like them, to exist.

(2) Shareholder consequences

(a) Individual shareholders.

Under present law, a distribution by a corporation to a shareholder in redemption of stock is considered an exchange event by the shareholder if it sufficiently reduces the shareholder's interest in the earnings or assets of the corporation (section 302), or constitutes a complete or partial liquidation of the corporation. A partial liquidation is defined generally under section 346 as a distribution of a 5-year active business (or the proceeds of its sale) when the corporation retains a 5-year active business (section 346(b)), or a distribution which otherwise results in a sufficient contraction of the corporation's business (section 346 (a)(2)).

S. 2687 and S. 2547 would repeal the corporate contraction provision of section 346(a)(2), with the result that such distribution will be tested under the general rules of section 302. In the case of an individual shareholder, the bills, by adding to the Code new section 302(e), continue to accord exchange treatment to the division of the 5-year businesses, as presently provided in section 346(b).

We believe these results to be sound. The corporate contraction test is vague and difficult in application. Furthermore, from a tax policy standpoint, it is difficult to see why a pro rata distribution to shareholder from an ongoing corporation with sufficient earnings and profits should not be taxed as a dividend. If the shareholder's interest in the corporation is sufficiently reduced by reason of the distribution, section 302 appropriately provides capital gains results. If such interest is not reduced, the distribution of assets (or the proceeds of their sale) is nothing more than a withdrawal of earnings. Traditionally, such withdrawals have been taxed at dividend rates.

We recognize, however, that certain types of divisions may be entitled to special treatment. At times, in the context of small, closely-held corporations, two (or more) businesses which have long been actively conducted by the family are divided among family members. We would agree that it may be appropriate to accord preferential capital gain treatment upon the receipt of one of those businesses by an individual shareholder. The bills accomplish this result through new section 302(e).

(b) Corporate shareholders.

Under present law, no distinction is made between individual and corporate shareholders with respect to distributions in partial liquidation. Thus, for a corporate distributee, capital gain results in both the section 346(a)(2) and section 346(b) distributions. Under S. 2687, both of these distributions will be tested for dividend effect under the reduction in interest rules of section 302. Under S. 2547, the present section 346(b) distribution is accorded exchange treatment to corporate as well as individual shareholders, without regard to the reduction in the distributee's interest.

In the case of a corporate distributee, we believe it is appropriate to test both the section 346(a)(2) and section 346(b) distributions under the rules of section 302. In general, this will result in dividend treatment, which will have little tax impact. Because of the dividends received deduction, most or all of the distribution will escape tax to the distributee, and the distributee will receive a carryover basis for the assets distributed. We believe the absence of a tax effect in the case of pro rata inter-corporate distributions to be an appropriate result.

Furthermore, use of the partial liquidation by a corporation recently acquiring the stock of a second corporation has been a vehicle by which the acquiring corporation can achieve a selectivity of asset basis with respect to the acquired corporation. As described more fully in part three of my testimony, we believe selectivity -- the ability to pick and choose as to asset basis -- to be inappropriate. While S. 2687 contains provisions which specifically provide for consistency of treatment by the buyer in the case of an acquisition, requiring a carryover basis to the distributee corporation on a nonliquidating distribution is an important back stop to those rules.

d. Impact on closely-held businesses

We recognize that the changes in the bills may restrict planning opportunities in the case of closely-held corporations. We believe, however, that such restriction is appropriate. To illustrate, assume brothers A and B disagree as to business philosophy and agree to split up the businesses long conducted in the family corporation. If the business has been conducted for five years, under section 355 of the Code the family corporation can be divided into two, with no tax at the corporate or shareholder level (and no basis step up in the corporate assets), and each brother may go his own way. If, however, A or B wants to withdraw assets from corporate solution, the changes made by the bill will apply. If B receives business assets, B will continue to be taxed at capital gains rates if the distribution satisfies the standards of present section 346(b) or substantially reduces B's interest in the corporation. The principal difference from present law is that the distributing corporation will be taxed on the appreciation on the assets distributed to B.

While, under present law generally no tax accrues to the corporation on this distribution, logic and policy do not support this result. The assets distributed to B may have appreciated substantially in value while in the corporation. Upon receipt of the assets B will receive -- generally at the cost of a capital gains tax -- a fair market value basis, which will result in depreciation deductions against ordinary income. The appreciation which accrued at the corporate level will only be taxed to B and then only at capital gains rates. If this has been a time-honored planning technique, we believe it is unduly generous and should be eliminated.

e. Effective date

These rules will apply to distributions made after August 31, 1982 (or redemptions completed after May 19, 1982 in the case of S. 2547), although certain transition rules apply. We wish to emphasize, and believe that the Committee Report makes clear, that this effective date is not to affect transactions which, under existing law, are in substance asset sales by the distributing corporation rather than redemptions. As indicated, we believe that certain transactions which have already been consummated may be recharacterized as asset sales, and we believe it appropriate to reiterate that such recharacterization is not forbidden by this legislation.

II. Improvement to Section 334(b)(2) Rules

Presently, under section 334(b)(2) of the Code, when a corporation (P) purchases 80 percent or more of a second corporation (T) over a 12-month period, P, upon liquidating T, will receive as its basis in T's assets its basis in the T stock purchased. The general purpose of section 334(b)(2) is to equate, for basis purposes, a purchase of stock followed by a liquidation with its functional equivalent -- a direct purchase of assets. Correlatively, T will be taxed on certain recapture items (e.g., certain recovery deductions on real or personal property, investment tax credit (ITC), the recapture amount attributable to LIFO inventory, and gain on certain installment obligations).

While perhaps sound in theory, in practice section 334(b)(2) has resulted in a number of problems and abuses. First, the required actual liquidation may be difficult and complicated, thus proving to be an obstacle in effectuating asset acquisition treatment. Further, under present law, up to 5 years may elapse between the acquisition of control and the completion of the liquidation. In the interim, P, by filing a consolidated tax return with T, may make use of T's tax attributes. When T is liquidated, the recognized recapture gain may be absorbed by losses or credits of the consolidated group. Also, as T will be an ongoing, operating company prior to liquidation, adjustments to asset basis are necessary to reflect T's earnings, losses, or distributions to shareholders. The adjustments now required are extremely complicated and may result in increases to basis which are not appropriate.

In section 201, S. 2687 would provide a solution to these problems. This section repeals section 334(b)(2), replacing it with a new section 338. Section 338 provides generally that, where P purchases at least 80 percent of the stock of T over a 12-month period, P may elect to step up the basis of the assets of T. This election is made 75 days after the acquisition of control (which period may be extended under regulations) and is irrevocable. If the election is made, T is treated as having sold all of its assets to a new corporation, on the date 80-percent ownership is achieved, in a transaction described in section 337. The price deemed paid is P's basis in the T stock on the date of 80-percent ownership or, if higher, at the close of the 12-month period. Similarly, T will recognize the items liquidating corporations usually recognize under section 337 (recapture, etc.) As the Committee Report confirms, the gain cannot be offset by any losses or credits of P or its consolidated group.

The Treasury Department believes that the new section 338 makes substantial improvements to the Code. It eliminates the requirement of a liquidation and treats with greater similarity a deemed asset purchase and an actual asset purchase. Thus, the acquired corporation's tax attributes are not available for use by the buyer, and the buyer's attributes are not available to offset the tax to the seller. Additionally, uncertain and complicated basis adjustments required by an extended period of operation are avoided.

Attempting to solve the problems with section 334(b)(2) by requiring the liquidation to occur within a shorter period, as some suggest, does not adequately deal with the problems involved. The goal is to treat, to the greatest extent possible, a section 334(b)(2) transaction as an actual asset sale. Shortening the liquidation period does not avoid an interim meshing of T's and P's attributes, which would not occur if T sold assets to P. Thus, T's recapture gain could still be offset by losses of the P group, and some (albeit fewer) interim adjustments would be required.

One technical issue which arises under the new section 338 is the basis to be accorded to the acquired assets. If P acquires 100 percent of T, the basis generally will be the fair market value of T's assets. If P acquires between 80 percent and 100 percent of T, however, complications arise. Under existing law, in the case of a section 334(b)(2) liquidation of T, a full fair market value basis for the distributed assets generally results. However, minority shareholders of T will have received assets from T, or stock or property from P, and will generally have been taxed on such receipt. Under section 338, as T's minority shareholders are not taxed by reason of P's making the election, the full basis step up as accorded by section 334(b)(2) is not appropriate.

There are basically three solutions to this problem. The first is the approach taken in S. 2687, which provides basis based on P's purchase price on the date control is acquired, or, if higher, at the close of the 12-month acquisition period. This proportionate basis step up rule may present problems since it treats 100 percent of T's assets as being sold for less than 100 percent of value. A second alternative is to provide a full 100 percent basis, but to tax the minority shareholders upon P's making the election, as is generally the case in a section 334(b)(2) liquidation. Taxing a minority shareholder, however, may be unfair where that shareholder sold no stock, had no idea that other stock was being acquired, and is otherwise completely unaware of the transaction. A third possibility is to provide full basis step up, but at the cost of recognition on the portion of the gain attributable to the interest not acquired by P in the transaction. The full basis rule prevents the need for later adjustments in the event P acquires additional T stock, may simplify required computations, and generally prevents distortions arising from the approach taken in S. 2687. The rule, however, may provide excessive tax where all shareholders of T are taxed in the acquisition, but P acquires less than 100 percent of T, as in such case an additional corporate level tax would be levied. This rule may also work imperfectly where P owns T stock which it acquired before the beginning of the acquisition period, since it would require gain recognition attributable to such stock.

While none of these solutions is perfect, on balance, we believe that the 100-percent basis step up with proportionate gain recognition to be the preferable approach.

III. Selectivity

The third part of S. 2687 prevents a corporate buyer from treating an acquisition in part as a stock acquisition and in part as an asset acquisition. The problem responded to is this: Corporation T may have certain high value, low basis assets which a purchaser (corporation P) desires to acquire with a fair market value basis for cost recovery purposes. T may have other assets, also desired by P, but whose tax detriments (e.g., recapture) outweigh the value of a fair market value basis. If P acquires all of T's assets, all would receive a fair market value basis and T (assuming adoption of a section 337 plan of liquidation) would recognize recapture items on all assets. Similarly, if P purchased all of the T stock, P would receive either a fair market value basis for all assets (with attendant recapture) if a section 334(b)(2) liquidation were undertaken, or would preserve T's historic basis for those assets (with no gain recognition) if T were not liquidated. Under existing law, however, by dispersing assets among subsidiaries, by causing a partial liquidation after an acquisition, or by any number of other techniques, P and T can achieve both results -- stepped up basis on some assets (generally at the cost only of recapture on those assets, which recapture may be deferred or avoided if a consolidated return is filed) and carryover basis on other assets (without triggering their tax detriments).

We believe this result is inappropriate. The ability to pick and choose as to asset basis (with the present attendant tax consequences) has been abused and has provided an incentive for certain corporate acquisitions. Since potential cost recovery deductions make some assets more valuable to buyers than to sellers, the tax laws provide some incentive for the sale of assets. Where some desired assets are acquired with a basis step up, while other desired assets are acquired without triggering any tax detriment, the incentive escalates. If P desires to make an acquisition from (or of) T, P should take the bad with the good with respect to the property acquired.

The bill moves toward this result by prohibiting selectivity by P with respect to acquisitions from T. Thus, the bill provides that all stock acquisitions meeting the section 338 requirements, and taxable asset acquisitions outside of the ordinary course of business, by a single buyer from a single seller in a single transaction shall be treated consistently. Asset acquisition treatment governs. A single buyer (or seller) is defined generally as an affiliated group of corporations (determined without regard to the section 1504(b) exceptions). A single transaction generally is considered to include all acquisitions within a period beginning 1 year before the beginning of the section 338 acquisition period and ending 1 year after the date 80-percent ownership is achieved. When an 80-percent stock acquisition is spread out to avoid the 12-month section 338 rule, and assets (or other subsidiaries) are also acquired, the Internal Revenue Service has the authority to treat the stock acquisitions as meeting the 12-month rule. Similarly, the Internal Revenue Service has the authority to extend the consistency period where the taxpayer has a plan to make several acquisitions from the same seller while waiting out the applicable period. The bill also provides very broad regulatory authority to reach other transactions undertaken to avoid the consistency objective, including the ability to disregard any provision of law or regulation (including the consolidated return regulations).

As I testified on May 24 before the Subcommittee on Select Revenue Measures, this "all or nothing" approach is a rational, logical and workable solution to the problems involved in selectivity. This is not to say that other solutions may not also be viable. A complete repeal of the General Utilities doctrine, which provides generally that corporations recognize no gain or loss on certain sales and distributions, is also an approach worthy of consideration. A complete repeal of General Utilities, however, would have ramifications beyond the problems at hand. Further, consideration of repeal must necessarily take into account the dramatic impact of those consequences. Complete repeal of General Utilities would mean that we have a true double tax at the corporate and shareholder levels. To eliminate or mitigate this double tax, some integration of the corporate and shareholder taxes would be required. Although integration has been the subject of a great deal of discussion over the years, it is, of course, a highly complex and far reaching change in the tax laws. In the absence of integration, death would be the only means to amend the two-tiered tax, and even then the corporate tax would continue to be applicable. By the same token, and without the significant collateral consequences, the all or nothing approach of S. 2687 is responsive to the problems at hand.

It may be argued that the all or nothing approach is inappropriate since the rules can be avoided. Such slippage always occurs when the Code (and especially subchapter C) is amended to curb abuses. In this case, the slippage occurs because of the mechanical rules prescribed to define a single buyer and seller and because of the exception made for reorganization transactions. However, these "avoidance" techniques may require a substantial change in the economics of the transaction -- perhaps to the degree that the deal will not be undertaken -- and to this extent we question whether the rules have in fact been avoided. Further, for those transactions in which the economics are not changed but the form is modified to circumvent the rules, the bill provides the Treasury broad regulatory authority to disregard rules of law and regulations which are used in attempting to achieve this result. Exercise of this authority, we believe, can stop some of the abuses which may otherwise occur.

Finally, it may be argued that the abuses in this area arise merely by reason of the consolidated return rules, and the solution therefore rests entirely within the jurisdication of the Treasury. Amendment of those regulations may in fact cure some abuses stemming from the ways recent transactions have been structured. The consolidated return issues, however, are only one part of the selectivity problem. Further, such amendment will not prevent taxpayers from structuring their affairs to achieve selectivity in other ways.

I would also like to point out that we have identified certain problems with the all or nothing rules as they relate to corporations which conduct business overseas. Because of the different U.S. tax treatment of domestic and foreign corporations under the Code, the effect of the rules as they apply to foreign corporations, DISCs, and section 936 corporations differ from those applicable to domestic corporations. Application of the rules to these corporations may result in significant changes in the U.S. taxation of international business operations. While application of the rules is this context may be appropriate, we believe it would be helpful to allow the Treasury broad authority to prescribe regulations which exempt some of these corporations under appropriate conditions.

As in any new approach to the tax laws, people will argue that the abuses do not warrant the solutions or that the solutions do not work. We do not believe this to be true. We think the all or nothing approach is rational, responsive to the abuses which generated it, and that it can and will work.

This concludes my testimony. I will be pleased to answer any questions you may have.

The CHAIRMAN. Mr. Chairman, if I may interject I do have to go to a food stamp hearing, which is a different matter, and I am coming back as quickly as I can.

But do I understand that the administration supports the provision that is in the Senate Finance Committee bill?

Mr. GLICKMAN. Yes, we do, Senator Dole.

The CHAIRMAN. And you have testified, in essence, as your lengthy statement would indicate, that you have no reservations about any part of the provision?

Mr. GLICKMAN. Well, we think that the bill in all three aspects achieves many very important purposes, and we do support all three measures in the bill. That does not mean that there could not be other solutions which might be more broadbased. But we think that the approach taken in the bill is correct, and we do support it.

The CHAIRMAN.. But you still have an open mind to some who have a different view that there may be, as you indicated, different ways to achieve perhaps the same result? You are open to that?

Mr. GLICKMAN. Senator Dole, undoubtedly, as I have told Senator Danforth, we will be more than willing to work with the staffs of this committee and various bar organizations and accounting societies to see if there is anything that is being missed.

It is certainly possible to take an action here which would be more of a bandaid and solve just the problems we see out there right now.

But as my testimony indicates, with respect to the distributions and partial liquidations, the Congress considered this problem in 1969 and built in some exceptions which you are now planning to revoke. At that point in time, the Senate Finance Committee did not build in any of these exceptions, and the only reason the Conference Committee built them in, as we understand it, was to give some time to study the issues to see whether there were abuses. Some of the abuses which have developed have developed, in our judgment, as a result of the fact that those exceptions were put in at conference in the 1969 act.

Now, like I said, you could make the changes much more narrow. If you did that, whether there would be additional problems at a future point in time, I cannot speak to.

We think from a tax policy standpoint the changes being made, especially with respect to the liquidation and distribution provisions, are appropriate at this point in time.

The CHAIRMAN. Thank you.

Senator DANFORTH. Please proceed, Mr. Glickman.

Mr. GLICKMAN. As I go through my testimony, I would also like to attempt to respond to some of the problems which other people have raised with respect to the bill. Undoubtedly, Mr. Chairman, we have not heard all the problems, but there will be someone from Treasury that will remain here for the remainder of the testimony, and if there is something we have not responded to, we will be happy to respond subsequently to that.

I think, even though it is not in my statement, it might be well to set the stage a bit as to how this legislation developed and the timespan that it has been under consideration, because one of the problems which many people raise is that there has not been sufficient time given to the consideration of this bill.

A bill similar to this was introduced in the House on May 6 of this year, H.R. 6295, which Senator Metzenbaum referred to. This bill was not a Treasury initiative. It was sponsored by Congressman Stark. But Treasury did testify with respect to that bill. There were many, many hours spent by Treasury, by Joint Committee, worrying about the issues.

When we testified, we pointed out many of the problems which we saw in that bill, but commented to the effect that there were problems to be concerned with and abuses which we thought needed to be faced up to, and recommended various types of approaches that could take care of those abuses.

From that point forward, the Treasury with Joint Committee and Ways and Means staff worked on drafting a bill, making various changes in it, and also worked with your staff, I believe, in trying to come up with a piece of legislation which we felt would solve these problems. And I think that that approach is set forth in S. 2687.

So the point I am really trying to raise here is that even though less than 2 months has expired since the original introduction of a bill in this area, a great deal of work has been expended by both Treasury staff and joint committee staff in considering this issue.

That does not mean that there are not differences of opinion. And I will assure you that if we spend the next 3 years studying this issue, there are going to be people differing as to the approach that should be followed to rectify some of these problems.

But again, I do want to make the point for the record that a great deal of time and effort have been expended in considering this problem. So it is not merely just an initial reaction that your bill represents or that my testimony represents.

I think that I would like to go through just very generally the various provisions of the bill, without getting into the specifics, and try to demonstrate the problems as we saw them and how we think the bill rectifies them.

It seems to me that the bill in its entirety really is responsive to a number of transactions that have occurred over the last months or perhaps years in which abuses have been perceived. I think that in your opening statement and in Senator Metzenbaum's statement some of these types of transactions were set forth.

As a result of these transactions, thought was given to the type of legislation needed to stop the abuses. I would like to talk first about the provisions of your bill which are in title I concerning distributions.

As a general proposition, if appreciated property is held by a corporation and is sold for cash, that sale will be taxable at the corporate level. However, if that property was distributed to shareholders, at least prior to 1969, there was no tax, as a general proposition, on that distribution.

The type of transactions that we have been seeing, at least some of them, involve transactions where corporation A would want to buy the stock of a subsidiary, for example, of corporation B. But if it bought that stock, that would be a taxable transaction to corporation B.

So what corporation A does is it buys the stock of corporation B, and then has corporation B redeem out that stock ownership in exchange for the stock of that appreciated subsidiary. So that if corporation A had bought the stock directly, there would have been a tax at corporation B's level. By going through this circuitous type of route, they avoid the tax at corporation B's level. And this is one of the types of abuses that we have seen.

Now, in that type of transaction, if it is wired together—in other words, corporation A and corporation B have a deal going in that as soon as A acquires the stock of corporation B, they are going to go through the transaction—we at Treasury and the Internal Revenue Service feel that that is the type of transaction we probably can get to without legislation.

But in the type of situation where there is no wire—and this happens, I would assume, in many types of unfriendly takeovers, where a corporation goes out and tries to take over another corporation, does not end up with control but ends up with a block of stock, and then subsequently they negotiate a redemption out of part of that stock for an appreciated property—that would not generate gain at the corporate level.

Now, in the 1969 act, section 311(d) was added which, in essence, says that if stock is redeemed with appreciated property, that will trigger gain at the corporate level. And this committee, as I stated earlier, left the rule in that context stating, in essence, that that type of transaction is tantamount to the sale of the stock, and the corporation distributing the stock to its shareholders in redemption should pay tax on that appreciation.

As I said, in conference some exceptions were added, upon which the type of transactions I have just now described were based, which said that under certain circumstances redemption of stock with appreciated property will not trigger gain at the corporate level.

Obviously, the bill that we are looking at right now will remove those exceptions and will, in essence, provide that gain at the corporate level will be taxed whether the asset involved is sold to an outside third party or is transferred to one of the shareholders in redemption of stock.

Now, there is no question, Mr. Chairman, that the approach of the bill goes farther than the abuses. In other words, the abuses I gave you were when a new shareholder comes into the corporation and then either in a transaction that is already locked in or in a transaction in very close proximity, the stock is redeemed out with appreciated property.

But we believe, Mr. Chairman, that the initial statement of this committee in 1969 is correct, that either way you go what is happening is a going corporation transferring appreciated property out and instead of selling it to a third party, it is selling it to one of its shareholders in exchange for the stock. And that should be a transaction which generates gain at the corporate level.

Obviously, we can fall short and put some sort of rule in, as people have recommended, saying that the stock has to be held for 3 years or 1 year or 5 years or whatever. But again, I think that that is a band-aid; that does not get to the heart of the problem of whether a corporation should be able to transfer assets that have appreciated in value without paying any tax with the purchaser receiving a step-up in basis in that type of transaction.

Now, the partial liquidation provisions are, in our view, similar to this. Again, if a corporation transfers part of its business to a third party in exchange for cash, that will generate gain at the corporate level. However, under section 336 of the code, under certain circumstances which are referred to as partial liquidations, if that same corporation distributes that business out to one of its shareholders, no gain would be recognized at the corporate level on that type of transaction.

So you have the anomaly, again, that if an outsider came in and bought the business for cash, there would be gain triggered at the corporate level, but again you can go around that, and avoid the gain at the corporate level.

This provision has been in the code for many, many years. There are many people who argue that it is almost historic. Yet at the same time, I think, when we look at this type of transaction and compare it to the redemption situation, we see very little difference. And we would take the position in this type of transaction that there should be gain generated at the corporate level.

We do draw a distinction between the distribution to a corporate shareholder as opposed to a noncorporate shareholder. But in many respects, that is more of a technical aspect of how the bill works rather than a specific substantive point. It is substantive, but the approach could go either direction on that.

I would now like to move to the second part of the bill. But before I get out of this, I would like to mention one other thing. One of the criticisms which we have been hearing concerning the partial liquidation and redemption provision concerns the effect of these on closely held or small businesses.

The example which is traditionally given is one of two brothers who have been in business for many, many years, and who are running either two factories or two stores, and who fall out of favor with each other and do not want to live together anymore. And what they do is take one of the businesses and distribute it out to one of the brothers in exchange for his stock. What the bill does is trigger a gain at the corporate level and then another gain at the shareholder level on that same distribution.

It is argued that is unfair. Under current law, all that is triggered is a capital gain at the shareholder level.

Now, in certain respects, Mr. Chairman, I understand the argument. But we have to remember that assets are coming out of corporate solution. They are getting a step-up in basis. The new basis will be, presumably, depreciable under the new ACRS method and thus will be offsetting ordinary income.

There is a way that these same people can accomplish the same result without any tax. For example, if the businesses have been in existence for 5 years, they can split those businesses up in what is called a splitup. What they would do is take part of the business, put it into a new subsidiary, transfer that subsidiary out to one of the shareholders in exchange for stock, accomplishing a split of the business. Everything remains in corporate solution. In that type of transaction there should be no tax to any of the parties involved.

Likewise, there is no step-up in basis; all we have done is taken the single corporation and divided it up.

So there is a way around the problem. The question you may still have is, well, why should there not be a way around it if they want to take one of the businesses out of corporate solution? And that gets us right back to the question of whether one ought to be able to make a distribution of a business out of corporate solution to one of the shareholders without any tax being generated to the corporation, whereas if that same corporation had sold the business to a third party there would clearly be a gain at the corporate level.

And again, Treasury believes that based upon the similarity to the redemption situation, we think that that is inappropriate.

So in the small-business context, there are, in many situations, ways around the problem. And I do not think the bill is quite as severe as some of the criticism we have been hearing.

I just would like to touch on the effective date issue, Mr. Chairman. As you know, the rules concerning distributions will apply to distributions made after August 31 of this year. We want to make it clear that certain of those transactions which were out there, certain of which have been discussed here this morning, are not grandfathered under this provision.

We think, as I stated earlier, that under certain of those transactions, we can characterize them as a sale at the corporate level under current law. And we would certainly want to make sure—and we think that this is the case under the grandfather provision—that the Internal Revenue Service still has the right to review those transactions to see whether under current law they are really a sale of assets which was just cast as something other than that.

Obviously, there are many transactions out there where people have moved based upon current law. And we would hope that we would be able to come up with a rule that would make sure that no one who has relied on current law is injured at least within some realm of reasonableness.

I would like now to move to a second portion of the bill, which is the improvement to the section 334(b)(2) rules. As you know, Mr. Chairman, and as I am sure the committee knows, if corporation A buys the stock of corporation B and then liquidates, that is tantamount to the acquisition of the assets.

Section 334(b)(2) sets forth the rule that says that if you buy stock and then liquidate, you get a step-up in basis on the assets on liquidation. It puts corporation A in much the same position as if it had bought the assets rather than having to go through the acquisition of stock. And in many transactions, the only way the deal will be done is through the acquisition of the stock.

Now, the provision that is in the bill, in our judgment, would simplify the rules greatly. First, it would not require an actual liquidation of the acquired corporation. It would allow the acquired corporation to continue in existence, and election would be provided that you could make that election and get the step-up in basis at the acquired corporation's level.

Many problems have arisen over the years concerning the forced liquidation in this context. And I think that this would simplify the law. At least in our judgment, it would be a simplification.

In addition, based upon the length of time under the present rules that you have in which to accomplish the liquidation that I have mentioned, there have been abuses which have arisen. We have shortened the time, and we have made the election retroactive back to the date on which control was acquired, which we think will take care of many of the abuse situations.

We think that this is a clear improvement of the Internal Revenue Code and something that will add both simplicity and also remove some of the abuses that have been perceived over the years.

Finally, I would like to talk about the final part of the bill which concerns the selectivity issue or, as some people refer to it, the selective electivity.

As I said, Mr. Chairman, if you buy a business, there are two ways that it can be accomplished: You can either buy the assets, or you can buy the stock. If you buy the assets, you get the step-up; if you buy the stock, as I said before, under present law you would have to liquidate in order to get the step-up in basis.

If you do not liquidate that corporation, although you have a high basis in the stock, assuming the assets in the corporation are high-value, low-basis, you still carry, until you go through that liquidation, the low basis in the assets at the acquired corporation's level. That is what the other provision says, that you can make the election to get the step-up in basis without going through the liquidation.

Now, that is fairly simple if you just buy all assets of a corporation or you buy the stock of one corporation and totally liquidate. But as the law has developed, there are many problems, or many potential problems, which have developed in this area.

I guess one of the first examples that we have been looking at is the situation where corporation A buys the assets of corporation B and some of the assets are in corporate solution and some of the assets are owned directly. So it is buying certain assets directly, and then it is buying stock of subsidiaries that also have assets.

The question in that type of situation is, should you be able to pick and choose, get a step-up in basis in certain assets and a carryover basis in other assets. Now, this becomes significant because of what is commonly referred to as the toll charge that has to be paid for the step-up in basis. That toll charge is generally recapture of depreciation or investment tax credit items, et cetera.

So you find people in the position when they are looking at an acquisition, they see two assets out there; they would like to have perhaps a step-up in both assets; but they want the step-up in basis in one asset, and that has no real recapture overtones to it. But the other asset would, if they got the step-up in basis for it, have substantial recapture.

Thus, they would look at the transaction and determine that what they want to do is step up the basis of one asset, the one that has no recapture, but leave the lower basis in the other asset because they are not willing to accept the recapture of income and pay that tax on that to get that step-up in basis.

The question really is, should a corporation be able to tax-plan in that format and just pick and choose? Corporations would, in essence, start managing their affairs in such a fashion, or have managed their affairs in such a fashion, to put themselves in a posture so that the acquiring corporation can pick and choose and determine where they want to pay the tax and where they do not.

The provision in the bill would, in essence, require an all-or-nothing approach. By that I mean is that it would say that if you buy all of the assets of a corporation, even though some of them are in corporate solution, in that type of situation you would be forced to take a step-up in basis for all the assets, and also pay tax on the recaptured income or credit with respect to those assets. If you did not want a step-up in any of the assets, you would not have to pay the recapture tax on any of them.

I think that the consideration here is whether it is appropriate, as I said, to let corporations plan in such a fashion. The tax overtones become a major item in the negotiations in the transaction. And as I said, the provisions of the bill, in essence, adopt an all-or-nothing approach, either you get the step-up with the corresponding recapture or you have to take the carry-over basis.

Now, with respect to this provision, Mr. Chairman, we have studied it hard. There are a number of people who have disagreements as to whether this is the correct approach. We believe that the all-or-nothing approach, the anti-selectivity approach, is the proper approach in this situation. We think that it is inappropriate for companies to be able to pick and choose in this fashion.

Now, there are other approaches that could be taken. I think Senator Metzenbaum mentioned the General Utilities issue. That basically would state, in essence, that if you overrule the General Utilities provision, any time there is a distribution or a sale by a corporation, whether it is on liquidation, distribution, redemption, or partial liquidation, that would automatically trigger gain at the corporate level.

There are many people who feel that repeal of the General Utilities type of provision, thus forcing the double tax—one at the corporate level and one at the shareholder level—is the appropriate way to handle the problem.

There is certainly an argument. And Treasury is of the opinion that this certainly might be a way to handle the problem, although it is a much more basic change in the tax laws. It goes to a much broader type of transaction and covers many more types of deals.

It also gets, in my judgment, into the question of whether that would force you into considering the integration of the corporate system with the individual system. And all of these are very broad-based issues.

Senator **Byrd**. Well, now, a clarification, if I may interrupt at that point, Mr. Chairman.

That is not included in the tax package, is it?

Mr. **Glickman**. No, Senator Byrd. All I was saying is that you will hear today that this is another approach to the problem, an approach which, as I stated earlier, Treasury might feel in an overall review situation might be appropriate. But it is a much broader type approach. The approach taken here is much more limited than that approach. And we think at this point in time, taking all factors into consideration, that the approach adopted in the bill, the all-or-nothing approach, is the one that should be adopted.

Finally, there have been some people who have stated that we can really take care of these problems simply by amending the consolidated return rules. Undoubtedly, some of the problems can be taken care of in consolidated return amendments, and Treasury has opened a study project in the consolidated return area to consider changing some of these rules.

However, we believe that we can only go so far in making changes in the consolidated return area and this just is not far enough to take care of the type of problems that we have been outlining.

In conclusion, Mr. Chairman, I would like just to mention one other thing which has really come up as of a rather recent date. And this concerns the applicability of the selectivity issue in the foreign area, to foreign types of transactions where you have a U.S. corporation that owns a foreign subsidiary which may own other foreign subsidiaries.

We have attempted in the short period of time that we have had to see what effect this would have on those types of transactions. We have heard from various bar groups that have advised us that this is a problem. We understand the ramifications of what would happen. And we are not sure whether those ramifications should follow as it would in a domestic situation.

However, as I said, I do not think that we have thought all the way through this issue, and thus we believe that it would be very helpful if Treasury were allowed some authority to prescribe by regulations exemptions in this type of area if it is ultimately determined that we ought to exempt out the foreign transactions. This is something we will be studying further to see how it should play out.

Mr. Chairman, that is the summary. I know it is much longer than you might have wanted. But that is a summary of the provisions, and I will be happy to take any questions you might have.

Senator **Danforth**. Thank you, Mr. Glickman.

One of the points that is made by, or will be made, by another witness, Mr. Ginsburg, is the bills, he says in his testimony:

> The bill's condemnatory approach to selective electivity is unworkable, in my view, because the sophisticated corporate tax bar, retained by acquiring corporations able to afford these folk, will turn the statutory scheme into an affordable nuisance, leaving behind a giant trap for the less affluent.

In other words, his view is that with respect to the selective electivity provision there is a loophole or there are loopholes which could be availed of by knowledgable tax lawyers.

Now, obviously, the last thing we want to do is to just go through a drill, amend the Internal Revenue Code, try to correct a problem, and end up with a big hole in the middle of the correction. And I would like your views as to whether or not Professor Ginsburg's comments are well taken.

Mr. **Glickman**. Well, Mr. Chairman, we have discussed this in some detail with Professor Ginsburg. And we are very aware of his feelings in this area. And there is no question but that in the type of approach we are adopting we cannot be sure at this point in time that there is not something out there that somebody could do to get around it.

Senator **Danforth**. You are never sure of that, though, in the tax field, are you?

Mr. **Glickman**. Well, I would assume, Mr. Chairman, that if you let me write the bill, if we got rid of general utilities, in other words, if we said we are going to lock in the gain at the corporate level, that you are going to go a long way to prevent anybody from really ultimately gaming the system.

But short of that type of thing, you are always going to have something, some approach that someone will adopt, as I say, to game the system. And we are certainly cognizant of that. We are worried about that, because we do not want to make this either a trap for the unwary or something in which the only most sophisticated can get around.

In drafting, we have provided a provision, and I might just read it to you, in the bill which says that—

> The Secretary shall prescribe such regulations as may be necessary to assure that the purposes of this section—

Which is the selectivity section—

> to require consistency of treatment of stock and asset purchases with respect to a target corporation and its target affiliates, whether by treating all of them as stock purchases or as asset purchases, may not be circumvented through the use of any provision of law or regulation, including the consolidated return regulations.

Now, what we have tried to do here, Mr. Chairman, is give ourselves, give the Treasury Department authority in those situations. Now, remember, we are talking about the people who are intentionally trying to avoid the rules that we put out there. And what we have done is try to give the Treasury Department authority to draft rules and regulations to prevent those transactions.

Now, there may be some out there that, if people are willing to change the economics of the transaction sufficiently, that we will not be able to stop in any event. But if they change the economics sufficiently, then there is a real question of whether they are violating either the letter or the spirit of the provision that we have here. And we probably should have no qualms about that.

What we are really talking about with this type of provision is something with which we could stop the abusive type of cases. I am not going to speak to what Professor Ginsburg will say about that.

But this gives us very broad authority. I do not want this committee to be misled on that. It gives us broad authority to prevent an avoidance of what the Congress or at least what this committee, is considering doing with this legislation. And it seems to me in that regard that it is totally appropriate.

Senator **Danforth**. Well, what we want to do, I think, speaking for myself, what we want to do is to try to get at the really much publicized cases where there have been noteworthy acquisitions or transactions of one kind or another entered into really with the encouragement of the Internal Revenue Code.

What we are not trying to get at is the situation where Mom and Pop are in business together, Mom and Pop split up, they want to split up their business. And we do not want to hit that kind of a transaction.

You say, as I understand it, that in your view there are ways to accomplish that kind of a split-up without the tax consequences that this——

Mr. GLICKMAN. Assuming that Mom and Pop have been together for the requisite period of time and the business is severable, in my judgment, Mr. Chairman, they can accomplish that without any tax at the corporate level, without any tax at the shareholder level, provided that they are willing to leave the two businesses in corporate solution as the one business was. If they want to accomplish it in a manner in which they are trying to take one of the businesses out of corporate solution with step-up in basis that goes along with that, the bill would change the present rules.

Right now, what the law would require is a tax at the shareholder level, whoever the distribution is made to. We think in that type of situation it is totally appropriate for there to be a tax at the corporate level also because in our judgment there is a sale of an appreciated asset by the corporation.

Senator DANFORTH. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Why, Mr. Glickman, how does this affect, or does it, subchapter S corporations?

Mr. GLICKMAN. Well, Senator Byrd, subchapter S corporations are passthrough-type of entities, as you know. If you have a subchapter S corporation, many people will say that many of these problems are not as severe because you can avoid the double tax by use of a subchapter S corporation.

We have to keep in mind here that the whole discussion we are having is based on the fact that we are in a two-tax world; in other words, the corporate tax and the individual tax.

Senator BYRD. Well, let me change my question, for the sake of brevity. This legislation does not change the subchapter S nor make any fundamental changes in subchapter S?

Mr. GLICKMAN. No, Senator Byrd.

Senator BYRD. All right. Now, the second thing is, how does this affect a spinoff, or does it affect the spinoff?

Mr. GLICKMAN. It should not affect a nontaxable spinoff. In other words, this is what Senator Danforth and I were talking about, that if you can meet the requisite requirements of section 355, which are the spinoff rules, you still ought to be able to consummate a spinoff on a nontaxable basis at both the corporate level and the shareholder level. And this provision would not affect that.

Now, let me say this. Someone has said to me that they think that perhaps there is something that has been done that could affect a spinoff. And that was not intended. If so, that would just be a technical correction we would want to make to the bill.

Senator BYRD. Well, now, let us take an example. Corporation A owns 100 percent of the stock of corporation B. And that stock has been held by corporation A for 5 years. At the end of the 5-year period, under existing laws, am I correct, that corporation A can distribute the shares of corporation B to the stockholders of corporation A?

Mr. GLICKMAN. Nontaxable; that is correct.

Senator BYRD. Nontaxable. And this does not change that aspect of it?

Mr. **Glickman**. No, sir, it does not.

Senator **Byrd**. Thank you.

Senator **Danforth**. Thank you, Senator Byrd.

Senator Long.

Senator **Long**. Let me just ask this question. Could you split up a mom-and-pop grocery store into two grocery stores without a double tax under this bill?

Mr. **Glickman**. Senator Long, as I understand what the law is right now, if you can actually split that grocery store up into two businesses—in other words, a vertical severance of those two businesses—then you can have that vertical severance, in my understanding. Yes, you can do that under the law as it is right now. In other words, whatever you can do under the law in that regard, you can continue to do.

Senator **Danforth**. Thank you, Mr. Glickman. There will be somebody from Treasury remaining?

Mr. **Glickman**. Yes, Senator Danforth. One of our staff members will still be here.

Senator **Danforth**. Thank you very much.

Mr. **Glickman**. Mr. Chairman, I have one other piece of testimony.

Senator **Danforth**. Surely.

Mr. **Glickman**. Mr. Chairman, I am also pleased to appear before you today to present the views of the Treasury Department on S. 2224. This bill would provide taxpayers who make charitable contributions to qualified tax-exempt job training organizations with a tax credit equal to 20 percent of such contributions.

The Treasury Department opposes this bill. A brief description of S. 2224: The bill would grant taxpayers a tax credit equal to 20 percent of their charitable contributions to certain qualified tax-exempt organizations. To qualify, these organizations would need to be certified by the Labor Department as providing job training solely to handicapped individuals, economically disadvantaged individuals, and displaced workers.

Credits for the contributions would be permitted in addition to the deduction for the full amount of the charitable contribution. The credit would be available for all qualifying contributions made in taxable years beginning after December 31, 1981.

A contributor would be permitted up to $250,000 in tax credits per year for qualifying contributions. Subject to this annual limitation, the credit could be used to offset 100 percent of the contributor's tax liability for the taxable year in which the credit is used. Credits which are not used in the year of contribution could be carried forward 15 years and back 3 years. The carryback period would include taxable years prior to the effective date of the provision.

The administration certainly agrees, Mr. Chairman, that Federal assistance is needed in training disadvantaged individuals for new jobs. Thus, the administration supports S. 2036, the Training for Jobs Act of 1982, which was unanimously passed by the Senate on July 1, 1982. Under this bill, the Labor Department will allocate Federal resources to the 50 States in the form of job-training grants.

State Governors will have broad supervisory authority over the local programs, which will be designed and administered by Private Industry Councils consisting of a majority of private business sector members along with representatives of education, local government, organized labor, community-based organizations and others.

These Private Industry Councils will determine the types of programs that fit each locality's specific needs and how Federal funds can best be used to encourage other members of the private sector to participate in these job-training programs.

While training eligibility will concentrate on two targeted groups—economically disadvantaged young adults and economically disadvantaged families with dependent children—program operators will be able to use a portion of their funds for persons with other labor market disadvantages. This will include displaced and migrant workers, handicapped individuals, jobless veterans, and older individuals. We are advised that a portion of the job training programs to be funded by these State grants will, in fact, be conducted by the same tax-exempt organizations which S. 2224 would assist.

Also, in evaluating S. 2224, it is significant to note that this committee has just approved a 3-year extension of the targeted jobs tax credit. The targeted jobs tax credit provides tax credits to employers based on wages they pay to employees who are members of certain targeted groups. Although we have certain tax policy concerns regarding the targeted job tax credit, the administration supported an extension of this program.

The Treasury Department believes that if tax credits are to be used to provide Federal assistance to promote jobs for disadvantaged individuals, the approach of the targeted jobs tax credit generally is preferable to the approach of S. 2224. Though S. 2224 will assist in providing job training, there is no assurance that jobs will be available. Indeed, the credit can be taken by taxpayers with no jobs to offer.

In contrast, the targeted jobs tax credit is granted to employers who supply actual jobs, many of which will provide some form of on-the-job training. S. 2224 would also make possible a "double credit" with respect to a worker who is trained with contributed funds that generate a credit under S. 2224 and whose subsequent wages also generate a targeted jobs tax credit.

Furthermore, although we recognize the importance of job training for disadvantaged individuals, we question whether contributions to provide funds to charitable entities for this purpose should be granted more favorable treatment than contributions to charitable entities for other worthwhile causes. If a special tax credit were provided for charitable contributions in this case, it would be very difficult to deny similar tax credits for contributions to organizations that conduct research concerning crippling diseases, cancer, et cetera.

In addition, there are certain technical aspects set forth in my statement, and without going through them, I trust that the whole statement will be in the record.

Finally, the tax credits provided by S. 2224 will add complexity to the Federal tax laws and will decrease Federal revenues. The

Treasury Department estimates that the revenue losses will be $51 million in 1983, $41 million in 1984, $48 million in 1985, $58 million in 1986, and $68 million in 1987.

This revenue loss is particularly troublesome at a time when concerted efforts are being made to reduce the Federal deficit. For these reasons, the Treasury Department opposes S. 2224.

Senator **Long**. Did I hear you say that under the current targeted jobs tax credit——

Mr. **Glickman**. I am sorry, Senator Long. I could not hear you.

Senator **Long**. Did I understand you to say that, under the targeted jobs tax credit law, a person claiming the credit can do so even though he has not made a job available to anybody?

Mr. **Glickman**. No. I said to the contrary. I said under the targeted jobs tax credit there is a job available that is based upon the wages being paid by the employer. Under the credit involved in this provision, since it would be classroom work, the credit would be given to the charitable organization that sets up—I mean the credit would be given to the person that makes the contribution to the charitable organization that sets up the classroom work. But there might not be a job available once the person finishes the classroom work, and for that reason we believe that the targeted jobs tax credit is more pointed to the direction of actually creating the jobs.

Senator **Long**. Then you are saying that, under the proposed bill which you are opposing, the credit would be available even though there might not be any jobs there.

Mr. **Glickman**. Exactly.

Senator **Long**. Thank you.

Senator **Danforth**. Thank you very much, Mr. Glickman.

Next we have a panel consisting of John Nolan, Donald Alexander, Martin Ginsburg, and Herbert Camp.

STATEMENT OF JOHN S. NOLAN, CHAIRMAN OF THE TAX SECTION, AMERICAN BAR ASSOCIATION, WASHINGTON, D.C.

Mr. **Nolan**. Thank you, Mr. Chairman.

My name is John S. Nolan. I am chairman of the Section of Taxation of the American Bar Association, an organization of 25,000 tax lawyers. The views I present today are those of the Section of Taxation; they do not represent an American Bar Association position.

The Section of Taxation strongly supports the general objectives of S. 2687 that the tax system should neither encourage nor discourage corporate takeovers, and we propose specific solutions to the tax avoidance problems in this area that have been identified. We are deeply concerned, however, that the overly broad provisions of this bill would substantially affect many important transactions unrelated to corporate takeovers. In our written statement we have described how sweeping provisions of this bill, such as the elimination of the partial liquidation provisions, may create new tax inequities and add additional complexity to our already over-burdened tax system. We have indicated how this bill may inadvertently change the well settled tax treatment of many thoroughly valid shareholder adjustments, such as corporate split-offs where a disagreement arises among shareholders. We have identified other concerns as well.

These far-reaching results and implications require much more careful thought and attention than has been possible within the short time elapsed since this bill and its House counterparts have been proposed—a period of less than 60 days. As I have said, there are specific tax changes that should be made at this time to prevent unwarranted tax benefits in corporate acquisition transactions, and we suggest and strongly support such measures. This bill, however, would attack these relatively narrow problems by major changes in the tax treatment of corporations and their shareholders. This is unwise and unnecessary.

The Section of Taxation, the American Law Institute, and other professional organizations have devoted thousands of hours to improvement and simplification of the tax law, particularly in areas such as those addressed in this bill. The bill makes very little use of that accumulated work product. The issues involved are fundamental, and they are matters as to which the views and experience of the practicing bar and the academic community are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the congressional tax staffs, the Treasury Department, academics, and practicing lawyers and accountants. Accordingly, I urge this committee to adopt the narrow solutions we propose to the known tax avoidance problems that exist and to announce that within the next 2 years the committee will undertake a fundamental re-examination of corporate-shareholder taxation. If you do, the practicing tax bar will respond effectively and objectively in improving and simplifying our Federal tax system.

Turning now to the specific issues before us, this bill addresses three types of acquisition transactions in which the tax laws produce unwarranted tax benefits. They arise within the following broader classifications: First, partial liquidations; second, redemptions; and third, complete liquidations. The changes we urge today are relatively narrow in scope, but they respond fully and effectively to the identified problems. Our proposals will have the same revenue consequences as the provisions of the bill because they will achieve the same level of control over the transactions that are causing the existing tax avoidance.

The partial liquidation acquisition problem arises because the existing consolidated return regulations fail to require recapture tax consequences in partial liquidation transactions involving a subsidiary even though recapture does occur in partial liquidations outside the consolidated return regulations. This problem can be solved by a Treasury Department amendment to the consolidated return regulations, and we strongly urge that such amendments be made. It is rumored that such a change is presently in progress at the Internal Revenue Service. If not, this bill could require that such a change be made. It is not necessary or appropriate, however, to repeal most of the partial liquidation provisions of existing law to cure this problem.

The redemption acquisition problem arises where a corporation buys some of the stock of another corporation to acquire part of the business of the other corporation. The stock purchased by the acquiring corporation is then redeemed by the target corporation by a distribution of stock of a subsidiary owning the wanted business assets. The target corporation may avoid tax, although this is by no means certain, even though in substance it has disposed of the business assets in question.

Again, it is possible that the problem could be solved administratively by Treasury Department action. There are rumors that a revenue ruling addressed specifically to this problem may soon be issued. In any event, we urge that code section 311(d)(2)(B) be amended to require that the stock redeemed have been held by the person from whom it is redeemed for a substantial period of time, perhaps 2 years. A 2-year holding period requirement would effectively preclude the type of transaction under review. If the acquiring corporation must remain at the risk of the market in holding stock of the target corporation for an extended period, we do not believe that these transactions will occur.

It is neither necessary nor desirable, however, to impose a double tax burden on distribution of assets in virtually all stock redemption transactions, as this bill would do to solve this problem. The broad provisions of the bill are, in substance, simply a partial repeal of the general utilities principle of nonrecognition of gain at the corporate level on distribution of appreciated property. General Utilities may or may not provide the correct tax policy result, and that question can and should be debated at length by tax policy experts—economists, lawyers, and accountants. It is one important element in the fundamental issue whether the corporate and individual tax should be integrated, as they are in the tax systems of many other major industrialized nations of the world. Rational tax policy could either embrace the General Utilities principle in full or reject it in full. Rational tax policy cannot, however, embrace it only in part, and much mischief has and will come from attempts to do so.

The complete liquidation acquisition problem arises where one corporation purchases 80 percent or more of the stock of another corporation as the means for acquiring its total business activities. The acquired subsidiary is then liquidated. Ordinarily such a liquidation results in recapture tax liabilities. It is possible, however, under existing law that the recapture tax liabilities of the target can be effectively eliminated if the acquiring corporation has unused net operating losses or tax credits that can be utilized in a consolidated return against those liabilities.

The response to this problem in the bill is also overly broad. While the new election procedure contained in this bill is innovative and may upon further examination be found to have real merit, that conclusion is now uncertain. Procedures must be found to deal with minority shareholders. The bill fails to resolve this important problem. The bill would require that the new election apply to all corporate affiliates of the target. It is not all clear whether this is the correct result. If recapture liabilities are incurred with respect to certain affiliates, there is no readily apparent reason why a step-up in basis of their assets should be denied even though no step-up is sought with respect to the assets of other affiliates.

For the present time, the known tax problem in this area can and should be solved by a much narrower provision. The liquidation of the acquired company, not merely the adoption of a plan, should be required to be completed within 12 months after the stock purchase. Moreover, the amendment could state that, for the period from purchase through liquidation, the target would not be deemed affiliated with the acquiring corporation for consolidated return purposes. In this manner, the acquiring corporation and target corporation would be precluded from bringing their respective tax attributes into conjunction with one another.

So much for the specific problems at hand. If this committee undertakes a fundamental reexamination of corporate shareholder taxation, as we strongly recommend, we have much to offer in the way of simplifying the tax law. Thus, for example, the section of Taxation has developed a legislative recommendation providing uniform corporate reorganization requirements. Under present law, the tax-free reorganization area is permeated by subtle distinctions producing widely diverse and wholly indefensible tax results in substantially identical transactions. The American Bar Association recommendation would eliminate most of these inconsistencies and substantially simplify the law.

Thank you, Mr. Chairman. We look forward to continuing opportunities to work with this committee to improve our tax system.

[The prepared statement of John S. Nolan follows:]

STATEMENT OF JOHN S. NOLAN
THE CORPORATE TAKEOVER TAX ACT OF 1982 (S.2687)
COMMITTEE ON FINANCE, UNITED STATES SENATE

JULY 15, 1982

My name is John S. Nolan. I presently serve as Chairman of the Section of Taxation of the American Bar Association, an organization of more than 25,000 tax lawyers. The views I present today are those of the Section of Taxation; they do not represent a position adopted by the American Bar Association.

I am a member of a law firm that has advised, and is advising, clients as to transactions that would be affected by this bill.

General Effects

This bill seeks to address and resolve important tax policy issues affecting corporate acquisitions. While we agree with the objective of the bill that the tax system should neither encourage nor discourage corporate takeovers, we are deeply concerned that the bill's provisions would substantially affect many important transactions unrelated to corporate acquisitions. For example, the bill would repeal completely the traditional tax treatment of partial liquidations. It has been a fundamental element of our tax treatment of corporations and shareholders at least since the Revenue Act of 1924 that shareholders receiving property in a partial liquidation are entitled to capital gain treatment and that, except for recapture, there is no double taxation upon a partial liquidation. The bill would impose a double tax in the case of all partial liquidations and deny capital gain treatment at the shareholder level in some transactions that have traditionally been partial liquidations -- i.e., corporate contractions. The adverse effects of these changes on small businesses will be substantial and are neither necessary to solve tax avoidance problems nor clearly justified.

Similarly, the pro rata distribution of assets constituting a separate trade or business in a partial liquidation, with the shareholders continuing to hold and operate such assets in partnership form, without sale by them, can serve important business purposes. It may even be an anti-takeover measure. The shareholders pay tax on such a distribution. It is by no means clear that gain should also be recognized at the corporate level, with double taxation consequences, in such a case.

In like fashion, as hereinafter described, the bill substantially changes the tax consequences of stock redemptions and the purchase by a company of the stock of another company to acquire its assets. These changes go far beyond what is necessary to prevent any tax avoidance that has been identified. These unnecessarily broad changes will have very unsettling and unforeseeable consequences. They will add much new complexity to the tax system.

These far reaching results and implications require more careful and thoughtful consideration. While, as hereinafter described, we support specific actions at this time to prevent the tax avoidance devices in the corporate acquisition or takeover context that have come to light, we strongly oppose at this time, without much more study, the broad changes that this bill would make. As I testified on May 24, 1982, before the House of Representatives Committee on Ways and Means Subcommittee on Select Revenue Measures (a copy of which is attached), Congress should instruct its staff to work with Treasury and professional groups such as ours to develop more fundamental changes in the tax treatment of corporations and their shareholders in a rational, consistent, intelligent and comprehensive manner.

Section of Taxation Position

This bill addresses three types of acquisition transactions in which the tax laws produce unwarranted tax benefits. These three acquisition transactions fall within broader classifications, i.e. -- (1) partial liquidations, (2) redemptions, and (3) complete liquidations.

The Section of Taxation agrees that certain administrative and legislative steps should be taken at this time to deny these unwarranted tax benefits. We do not, however, believe that it is necessary or appropriate to make the broad changes in substantive tax law that the bill now contemplates. It is not necessary to make the broad changes because narrower actions are available that will cure the identified problems. It is not appropriate to make the broad changes because their consequences have not adequately been explored or debated by knowledgeable experts in the field.

The changes we urge today are relatively narrow in scope, but they respond fully and effectively to the identified problems. Our proposals will have the same revenue consequences as the provisions of the bill because they will achieve the same level of control over the transactions that are causing the existing tax avoidance.

Partial Liquidations

The partial liquidation transactions that have generated concern involve a particular pattern. An acquiring corporation purchases all of the stock of a target corporation. Some of the assets of the target have a low tax basis, and the acquiring corporation seeks to obtain a step-up in that basis without immediate tax cost to either corporation. Unfortunately, it can do so at present by -- (1) joining in a consolidated tax return with the target; and (2) causing the target to distribute the low-basis assets to the acquiring corporation in a transaction that will satisfy the definition of a partial liquidation under Code §346. Although transfers of assets from the target would normally result in recapture of both depreciation and investment tax credit, this tax result is avoided. It is avoided because the consolidated return regulations are overly generous in the case of partial liquidations. The regulations provide that no investment tax credit will be recaptured on such a transfer, and they permit substantial deferral of depreciation recapture.

This problem can be solved by a Treasury Department amendment to the consolidated return regulations, and we strongly urge that such amendments be made. It is rumored that such a change is presently in progress at the Internal Revenue Service. If not, this bill could require that such a change be made. It is not necessary or appropriate, however, to repeal most of the partial liquidation provisions of existing law to cure this problem, and the Section of Taxation opposes such a broad response to a narrow problem.

Redemptions

The redemption transactions of concern also follow a pattern. An acquiring corporation purchases part of the stock of a target corporation. The acquiring corporation does not intend to continue to own such stock and thereby maintain an equity position in the target; it intends only to use the stock acquired to obtain direct ownership of one of the target's several businesses, held in a subsidiary of the target. It does this by causing the target to distribute the stock of the desired subsidiary to the acquiring corporation in redemption of the shares of the target held by the acquiring corporation. After the redemption transaction has been concluded, the corporations go their separate ways, and the net effect is that the acquiring corporation has purchased a subsidiary of the target.

In this case, although the target corporation has effectively sold the stock of the subsidiary by distributing it to the acquiring corporation in redemption of some of the target's outstanding stock, the target has paid no tax on any appreciation in the value of that stock. It pays no tax because a redeeming corporation does not generally incur tax on appreciation in the value of property distributed in effecting a redemption. This is consistent with the general rule that appreciation in the value of property is not taxed when the property is distributed by a corporation to its shareholders.

This general rule was developed by the Supreme Court in 1935 in the General Utilities case and is now reflected in Code §311 (dealing with nonliquidating distributions) and §336 (dealing with partial and complete liquidations). In the Tax Reform Act of 1969, §311 was amended to deny the General Utilities nonrecognition principle where appreciated property is distributed by a corporation in redemption of its own stock. Various exceptions were provided, however, and one of these exceptions (§311 (d)(2)(B)), adopted in 1969 for a very narrow purpose, has since been seized upon by acquiring corporations to avoid tax in the situation previously described. It permits a corporation to avoid tax where the property distributed in redemption consists of the stock of a controlled subsidiary of the redeeming corporation.

The Section of Taxation concurs that this problem should be resolved to prevent purchase transactions from masquerading as redemption transactions. Again, it is possible that the problem could be solved administratively by Treasury Department action. An existing Revenue Ruling of the Internal Revenue Service suggests a solution. Rev. Rul. 80-221, 1980-2 C.B. 107. Again, there are rumors that a further Revenue Ruling addressed more specifically to this problem is under consideration. In any event, we urge that Code §311(d)(2)(B) either be amended to require that the stock redeemed have been held by the person from whom it is redeemed for a substantial period of time, perhaps two years, or possibly that §311(d)(2)(B) be repealed in its entirety. In the latter event, however, provision should be made for non-recognition of gain at the corporate level in a non-taxable corporate division under section 355 in the nature of a so-called "split-off" where stock of an existing subsidiary is distributed in a redemption of the stock of a dissenting shareholder. S. 2687, in repealing §311(d)(2)(B) and other exceptions to §311(d) in their entirety, probably inadvertently failed to make provision for these corporate "split-offs" -- thoroughly valid forms of corporate division which are not acquisition transactions.

In our view, a two-year holding period requirement would effectively preclude the type of transaction under review. If the acquiring corporation must remain at the risk of the market in holding stock of the target corporation for an extended period, we do not believe that these transactions will occur. It would be appropriate to include in the committee report a statement of intent that the holding period would run only if the acquiring corporation were truly at risk -- arrangements which have the effect of eliminating market risk should preclude qualification even if there is formal compliance with the holding period requirement.

It is neither necessary nor desirable, however, to repeal all of the existing exceptions to §311(d) in order to cure this problem. Some of these exceptions may have substantial justification in a tax system such as ours which does not impose a double tax burden in certain extraordinary transactions. Sections 311(d)(2)(A), (C) and (G) have nothing to do with the kind of tax avoidance problem in a corporate acquisition at which this bill is directed. Code §311(d)(2)(A) may be of substantial value to small business.

The broad provisions of the bill are, in substance, simply a partial repeal of the _General Utilities_ principle of nonrecognition of gain at the corporate level on distributions of appreciated property. _General Utilities_ may or may not provide the correct tax policy result, and that question can and should be debated at length by tax policy experts -- economists, lawyers, and accountants. It is one important element in the fundamental issue whether the corporate and individual tax should be integrated, as they are in the tax systems of many other major industrialized nations of the world. Rational tax policy could either embrace the General Utilities principle in full or reject it in full. Rational tax policy cannot, however, embrace it only in part, and much mischief has come from prior attempts to do so.

Thus, when some distributions (e.g., redemptions and partial liquidations) are made taxable at the corporate level while others (e.g., ordinary distributions and complete liquidations) are not, immense tax differentials are created. These differentials result in pressure to avoid the more onerous classifications and to enjoy the more liberal ones. They necessitate much complexity in the tax system -- as indeed other provisions of this bill would add in seeking to distinguish partial liquidations and complete liquidations (see proposed new Code §346(b) to be added by section 101(d) of this bill). Any change in the existing points of balance should be made only after much more careful and extended consideration than has yet occurred. This is particularly so when a more modest solution to the identified problem is available.

Complete Liquidations

Under §334(b)(2) of existing law, if an acquiring corporation purchases eighty percent or more of the stock of a target corporation and causes the target to adopt a plan of liquidation within two years after the purchase, the basis of the assets of the target corporation can be stepped up to the purchase price of the stock. A consequence of the transaction is recapture to the target of depreciation and investment tax credit. It is possible, however, under existing law that the recapture tax liabilities of the target can effectively be eliminated if the acquiring corporation has unused net operating losses and/or tax credits that can be utilized in a consolidated return against those liabilities.

The response to this problem in the bill is also overly broad. It is unnecessary, and it may be undesirable, to repeal §334(b)(2) and to enact a new §338, under which the target corporation would elect to be treated as if it had sold its assets under §337 and liquidated. While this elective procedure is innovative and may upon further examination be found to have real merit, that conclusion is now uncertain. Thus procedures must be found to deal with minority shareholders, a not uncommon characteristic of this kind of transaction, and the bill does not now resolve this issue. Several alternatives for dealing with this problem exist, and they should receive careful consideration.

In addition, the bill would require that the election under §338 apply to all affiliates of the target, and it would also amend existing §337 to condition its availability to any one corporation on the complete liquidation of all affiliates of that corporation. It is not at all clear that this is the correct result. If recapture liabilities are incurred with respect to certain affiliates, there is no readily-apparent reason why a step-up in basis of their assets should be denied even though no step-up is sought with respect to the assets of other affiliates. These problems warrant careful consideration.

If the objective is to preclude unintended use of tax attributes of one corporation to benefit another, this can be resolved by much narrower legislation. Existing law could be amended to require that the liquidation of the acquired company (not merely the adoption of a plan) be completed within twelve months after the stock purchase. Moreover, the amendment could state that, for the period from purchase through liquidation, the target would not be deemed affiliated with the acquiring corporation for consolidated return purposes. In this manner, the acquiring corporation and target corporation would be precluded from bringing their respective tax attributes into conjunction with one another.

Other Considerations

We strongly support a fundamental re-examination by Congress of the tax treatment of corporations and their shareholders within the next two years. The American Law Institute, the Section of Taxation of the American Bar Association, and many other able professional groups have done much valuable study work in this area in recent years. The broad issue of integration of the corporate and individual tax needs much more consideration, and many economists have given extensive study to this subject. Our relationships with many other nations with integrated tax systems must be given further attention.

This bill itself has the very sound purpose of achieving a greater measure of tax neutrality by eliminating differences in tax consequences of substantially similar transactions. Toward the same end, the Section of Taxation has developed a legislative recommendation providing uniform corporate reorganization requirements. Under present Code §368, the tax-free reorganization area is permeated by subtle distinctions producing widely diverse and wholly indefensible tax results in substantially identical transactions. The American Bar Association recommendation would eliminate most of these inconsistencies and should be enacted promptly.

The Section of Taxation, the American Law Institute, and other professional organizations have devoted thousands of hours to improvement and simplification of the tax law. We are prepared to increase our efforts to provide a better corporate tax law. We cannot, however, achieve that goal in a few days or even a few weeks, in the kind of time frame that this bill and its House counterparts (H.R. 6295 and H.R. 6725) have imposed upon us. The issues involved are fundamental and are matters as to which the views and experience of the practicing bar and the academic community are particularly needed. The solutions would benefit greatly from careful, dynamic interaction between the Congressional tax staffs, the Treasury Department, academics, and the practicing bar acting through its institutions such as the Section of Taxation. Accordingly, I urge this Committee to adopt the narrow solutions we propose to the known tax avoidance problems that exist and to announce that within the next two years the Committee will undertake a fundamental re-examination of Subchapter C of the Internal Revenue Code. If you do, I assure you that the practicing tax bar will respond effectively and objectively in improving and simplifying our Federal tax system.

Senator **DANFORTH**. Thank you very much, Mr. Nolan.
Mr. Alexander.

STATEMENT OF DONALD C. ALEXANDER, ESQ., MORGAN, LEWIS & BOCKIUS, ON BEHALF OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, WASHINGTON, D.C., ACCOMPANIED BY RACHELLE BERNSTEIN, SENIOR TAX ATTORNEY, CHAMBER OF COMMERCE TAX POLICY CENTER

Mr. **ALEXANDER**. Mr. Chairman, my name is Donald Alexander and I am appearing here today on behalf of the U.S. Chamber of Commerce. I am accompanied by Rachelle Bernstein, a senior tax attorney for the chamber's tax policy center.

I do not propose to read any of my statement. I request that it be inserted in the record.

Mr. Chairman, the U.S. Chamber of Commerce agrees with what the U.S. Bar Association Tax Section representative stated. We think that the provisions considered this morning and at least tentatively placed in the committee's bill a couple of weeks ago go much too far to solve the perceived problems you have been discussing this morning.

We talked about certain identified companies that have engaged in particular transactions which may or may not work under current law, but to solve these problems a series of proposals are under consideration which go much further than required to remedy the abuses which may be present under current law. The question is whether you need to go further and whether to solve the well-publicized problems you need to take actions that Deputy Assistant Secretary Glickman described this morning as needed not only meet those problems but also problems that may be lurking out there somewhere, undefined problems.

As Mr. Glickman pointed out, one of the provisions to which these strong solutions are addressed has been with us since 1969. It is now 1982. Thirteen years is a long time for problems to surface, and indeed, some problems have surfaced. The Esmark problem, the United States Steel/Conoco problem, or the Dome Petroleum problem, all mentioned this morning, and all of which could be solved, as Mr. Nolan just pointed out, by a targeted mechanism which would not have the effect, as the U.S. Chamber believes the provisions before you would, of creating traps and massive problems for small business—small businesses that have enough problems coping with the Internal Revenue Code as it is.

Now, we were told earlier this morning that the solutions that we are proposing are Band-Aids. I suggest there is nothing wrong with Band-Aids, and when you have a small cut on your finger it is a lot better to have a Band-Aid than to have a cast. And the solutions the Treasury seems to be espousing represent a cast more than a Band-Aid. More than a cast because we would be casting aside, among other things, the partial liquidation provision that has been with us for at least 28 years and which is very valuable to small business.

The question was asked of Mr. Glickman this morning whether the repeal of this provision would leave a small business whose owners now have divergent ideas about the conduct of the business or a small business that happens to have two segments, one of which can no longer be conducted, with the ability to transfer one of those businesses or one of those segments to its owners tax free at the corporate level.

Now, Mr. Glickman responded that if certain conditions were met, indeed that could be done, tax free at the corporate level. He is right, if those conditions were met. The question is why you want to impose those conditions upon small business and why you want to treat the distribution of assets of a small business to one of its owners as a sale. It is not a sale to the owner. It is not a sale to the business. It may be a sale in theory to tax theorists, but we are talking about the real world, about the conduct of small businesses which frequently have to shuffle off part of their enterprise and want to do it without paying tax as if they had sold the property.

Now, we are told that this result must be changed as part of an antitakeover measure. That is not correct at all, as I see it. Instead, the ability of a small business to respond to changing circumstances by disposing of a segment without tax at the corporate level—other than recapture—helps the business avoid takeovers.

Finally, we are told that we should scrap section 334(b)(2) of the Internal Revenue Code dealing with the situation Mr. Nolan described, the acquisition of 80 percent of a corporation's stock followed by the liquidation of the corporation. We are told that we will substitute an elective provision under which an election must be made within 75 days, unless possibly extended by regulations, after the acquisition of stock to achieve somewhat the same result. This presents all of the problems that Mr. Nolan described and that which Professor Ginsburg has already identified and will discuss with you.

That election is going to be a trap for small business. They simply are not going to be able to cope with it.

Now, the present provision of the code is tough enough to cope with, but we have been learning how to deal with it for years. Why change unless the change is necessary and in the national interest?

The chamber submits that these problems can be solved without massive changes to our present system.

Senator DANFORTH. Mr. Ginsburg.

[The prepared statement of Donald C. Alexander follows:]

STATEMENT

on
S. 2678 and S. 2547
before the
SENATE FINANCE COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
By
Donald C. Alexander
July 15, 1982

My name is Donald C. Alexander. I am a member of the Taxation Committee of the Chamber of Commerce of the United States, for whom I am appearing today. I am a member of the law firm of Morgan, Lewis & Bockius, of Washington, D.C. I am accompanied today by Rachelle B. Bernstein, Senior Tax Attorney for the Chamber's Tax Policy Center. On behalf of the Chamber of Commerce of the United States, representing over 255,000 business, trade associations, and local and state chamber members, we welcome the opportunity to testify in opposition to S. 2687 and S. 2547.

S. 2687 and S. 2547, as well as provisions similar to those in these bills which have been included in H.R. 4961, the tax bill ordered reported by the Finance Committee, are stated to be directed at tax-motivated takeovers and mergers. However, their effect is to amend Subchapter C of the Internal Revenue Code to remove certain provisions which are commonly utilized by, and are materially beneficial to, small business so as to solve certain perceived problems of narrow application. Accordingly, we find a piecemeal revision of Subchapter C in which certain drastic changes are made with respect to partial liquidations and distributions of appreciated property, and certain consolidated return provisions. We believe that revision of Subchapter C should be made only after careful and thorough consideration of such thoughtful efforts as that recently concluded by the American Law Institute. Problems created by the well-publicized actions on the part of a few large corporations can easily be cured (if a cure is necessary) by changes much less drastic than those contained in S. 2687 and S. 2547.

Basically, S. 2687: (a) would remove from the Internal Revenue Code current Section 346, dealing with partial liquidations, (b) would greatly restrict the circumstances under which appreciated property may be distributed in redemption of stock without the recognition of gain to the distributing corporation, (c) would remove current Section 334(b)(2) from the Code and substitute an election to treat an acquisition of stock as an acquisition of assets, and (d) would make certain additional changes calling for consistent treatment of subsidiaries acquired in a single transaction. S. 2547 is to the same general effect.

The thrust of these bills is to deal with certain highly-publicized transactions by requiring the distributing corporation to recognize gain if, for example, corporation A should acquire stock in corporation B for the purpose of having corporation B distribute appreciated assets in redemption of such stock. If the so-called Esmark transaction is valid under current law and therefore creates a loophole, it can be dealt with in far less drastic fashion. A simple solution is to require a holding period of at least one year between the date of acquisition of the stock and the date of the redemption. Such a long period of time between the outlay of capital to acquire stock on the one hand and distribution of the desired assets on the other would create a true business and economic risk of such proportions as to discourage, quite effectively, the use of this technique. Moreover, the use of the present consolidated return regulations to which a similar result could be easily prevented by an amendment to the consolidated return regulations or by a statutory requirement that there be immediate recognition of income (rather than deferred recognition) unless the consolidated return regulations provided a contrary result.

It is not necessary, we submit, to go further than the solutions suggested above to solve the perceived problem created by recent transactions. The much more drastic remedies proposed in S. 2687 and S. 2547 would have a significant adverse effect upon small businesses, which need to utilize the partial liquidation provision, in particular, to make the transfers of assets to stockholders to permit a small business to survive ownership changes and changing needs among its owners.

For example, where two brothers who have owned and operated a closely-held corporation decide to split their business because of a family dispute, they might choose to distribute a portion of the business to one of the brothers in redemption of all of his outstanding stock. Under present law, the redeemed brother would be taxed on the capital gain he realized upon receipt of assets. The family company would be liable for statutory recapture. However, under the proposed amendment, not only would the redeemed brother pay full capital gains tax on the assets received, but the corporation would also pay a tax on the entire appreciation in value of the assets distributed. This double taxation of the appreciation of these assets is contrary to one of the basic tenets of our tax policy.

Another common transaction which would be adversely affected is a parent's sale of the family business to his children. If the children cannot afford to purchase the entire business, the father can sell a portion of his stock to his children at an affordable price, and the corporation can distribute some assets to the father in redemption of the remainder of his stock. Under present law, the father would pay capital gains tax on the appreciation in value of his stock and there would be a corporate tax only to the extent of recapture on assets distributed. However, under the proposed legislation, the corporation would be taxed on the appreciation of the assets distributed, and the father would be taxed on the appreciation of his redeemed stock, again resulting in a double taxation.

Present Section (334(b)(2), providing that a purchase of 80% of the stock of a corporation followed by a liquidation of such corporation is treated as a purchase of assets under certain circumstances, would be replaced by a provision permitting an election to treat a stock purchase as a purchase of assets. A new requirement of consistency would be enacted to require that all acquired subsidiaries be treated alike; i.e., the election is all or nothing. The new election would be required to be made no later than 75 days after the date of acquisition. Apparently, the principal purpose for this change is to prevent taxpayers form stringing out liquidations under Section 334(b)(2) by waiting until nearly the end of the permissable two-year period to commence the liquidation and then using the general three-year permissable period to consummate the liquidation.

The first question is whether this is an evil that should be cured. In my experience, most taxpayers in Section 334(b)(2) situtations commence and complete the liquidation of the acquired company as soon as they can. They want to avoid the complexities of current law and regulations with respect to post-acquisition earnings, losses, distributions, etc., and they see no advantage to delay. Current law and regulations are designed t produce neutrality; in other words, a taxpayer should neither gain nor lose by delay. While delay permits utilization of the acquired company's attributes, it also requires utilization of the acquired company's lower tax basis. Therefore, there are trade-offs.

If correction is warranted, the two-year period for commencement of the liqiuidation might be shortened to one year or, better, the period permitted for liquidation might be shortened. We see no reason for the replacement of Section 334(b)(2) with which taxpayers and practitioners have become reasonably familiar by a novel election required to be made within 75 days after the acquisition. This election will necessarily produce a trap, such as existed under the installment sales provisions until recently, for small businesses who cannot afford elaborate pre-acquisition examinations or sophisticated and expensive counsel.

Finally, we should repeat that efforts to discourage, through the tax laws, mergers and acquisitions of businesses should be viewed with skepticism and caution. Erecting tax barriers to business acquisitions has serious adverse consequences upon the economy and upon small business. Many business combinations produce beneficial results by permitting economies of scale, by lowering production costs, and by permitting small competitors to join so as to compete more successfully against a larger firm, whether in the United States or abroad. We find no credible evidence that the tax laws are leading to economic concentration, and we believe that revisions such as those proposed in S. 2687 and S. 2547 go further than necessary to cope with the "abuses" against which they are directed and would have serious adverse effects upon small business.

STATEMENT OF MARTIN D. GINSBURG, PROFESSOR OF LAW, GEORGETOWN UNIVERSITY LAW CENTER, WASHINGTON, D.C.

Mr. GINSBURG. Mr. Chairman, given the inordinate length of the written statement I submitted this morning——

Senator DANFORTH. All statements will be printed. You do not even have to ask.

Mr. GINSBURG. I was not going to. I was going to say that I was both startled and delighted to discover that you have taken the time to look at it, and I want to thank you.

The committee is today considering very important changes in important tax provisions. The legislation is largely a reaction to some perceived significant abuses under present law. They are perceived abuses because during the past couple of years it has been difficult to pick up the Wall Street Journal and not perceive them. Big corporations, big corporate acquisitions, and big avoidance of corporate tax.

That description may suggest that I favor enactment of title I of the bill, the proposed amendments to the stock redemption and partial liquidation provisions of the code. Indeed I do, most strongly.

Employing the current statutory rules, often coupled with segments of the consolidated return regulations and some byzantine acquisition techniques, purchasing corporations have attempted—and in a great many cases clearly have succeeded—in stepping up the basis of selected target corporation assets while deferring or eliminating entirely the corporate-level toll charge, the recapture taxes and the like that Congress thought it had imposed as the price of stepping up the basis of those assets.

Title I of the bill goes about its business in a nice, clean way. It does not attempt to make unsound distinctions between acquisition schemes that are bad and acquisition schemes that are worse. It does not specially reward the patiently devious, those who can afford to acquire a target corporation and wait 1 or 2 years before reaping inappropriate tax benefits. It avoids nice distinctions among the indistinguishable, and for that reason it will actually work. It is good tax legislation, it is long overdue, and it ought to be enacted.

Title II of the bill is a more complex piece of business, half good, half, I think, frightful. Title II proposes to replace present section 334(b)(2), a liquidation provision, with new section 338 under which the basis of all of the target corporation's assets automatically will be stepped up, and all recaptured taxes with respect to those assets promptly paid, through the filing of a simple election with the Internal Revenue Service.

Replacing present law's election-by-liquidation with a simple election form is, I think, an absolutely wonderful idea. Everyone benefits. Senseless asset transfer expenses and costly consents to be extracted from rapacious landlords are avoided, a number of tax abuses are eliminated, and, perhaps most important, the election system is designed so that we will for the first time enjoy an opportunity to harmonize and simplify in practice a large segment of corporate tax law.

There are naturally some significant technical problems in the statute as drafted, as you have already heard this morning. However, the very good committee report I read last night confirms that the staffs are well aware of most, if not all, of them. All of them are solvable. The committee report sensibly handles many, and I trust the handful that remains—minority shareholders, foreign corporations, and so forth—will be satisfactorily resolved before the bill becomes law. That is the good part.

There is, unfortunately, one segment of proposed section 338 that will not win the good tax legislation award. It is the all-or-nothing rule. It is bad news, and I can best explain it by a simple example.

Assume H corporation operates a hotel. The hotel is worth much in excess of its basis and has little in the way of recapturable depreciation or investment credit. W corporation operates a widget corporation also worth much in excess of basis, but recapturable depreciation and investment credit are burdensomely high. P corporation, which is to purchase both H and W, would like to step up the basis of the hotel assets and is quite prepared to pay the related capture taxes, but has no desire to step up the basis of the widget assets or to pay that confiscatory recapture tax.

Under present law, P is free to step up H and leave W alone. Under proposed section 338, P can still do this if H and W are owned by different sellers or if H and W are owned by one seller but that seller is not a corporation. If H and W are affiliated through corporate ownership, however, section 338 as drafted announces that P must step up everything or can step up nothing.

This is not very sensible. It is not a reaction to abuses of present law, since P in stepping up H's hotel assets will pay the congressionally mandated recapture taxes that relate to those assets. It is, I think, a rather strange notion that for H to step up its hotel assets W must pay recapture taxes on its widget business, and must do so if and only if the purchaser P is a corporation rather than say a partnership, an individual, a group of individuals, or even two unaffiliated corporations.

It is, moreover, as you have noted from my written testimony, a rule that absolutely will not work in practice. The tax bar, that marvelous collection of the most ingenious folk, will simply tear it to shreds.

In the written statement I have illustrated five different arrangements, none at all complicated, each of which allows P corporation, despite section 338, to do exactly what it wants to do: step up the basis of the hotel aspects, paying that recapture tax, avoid basis step up and recapture tax on widget assets, and pay the tax lawyer.

Now, I am only a poor schoolteacher. Think how many more and better schemes those real tax practitioners around me are going to conjure up.

I honestly think this is the most unfortunate sort of tax legislation. It will not accomplish a great deal, other than further, to complicate an already vastly complicated corporate tax law. It will generate reams of Treasury regulations that will attempt to protect an indefensible rule. It will entrap taxpayers that do not have access to the best and no doubt most expensive tax advice.

The explicit election concept in section 338 is an excellent one. Its enactment will be a boon to taxpayers and the taxing system.

The all-or-nothing rule that encumbers the balance of the proposed statute is unsound in concept and unworkable in practice. I urge that you retain the core notion of proposed section 338 and eliminate the miserable all-or-nothing rule.

Senator **Danforth**. You do not like it much?

Mr. **Ginsburg**. Not a lot.

Senator **Danforth**. Mr. Camp.

[The prepared statement of Martin D. Ginsburg follows:]

STATEMENT OF MARTIN D. GINSBURG
BEFORE THE
SENATE FINANCE COMMITTEE
ON S. 2687
JULY 15, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS MARTIN D. GINSBURG. I AM A PROFESSOR OF LAW AT GEORGETOWN UNIVERSITY LAW CENTER WHERE I TEACH VARIOUS SUBJECTS IN THE FIELD OF FEDERAL TAXATION. FOR SOME TWENTY YEARS PRIOR TO BECOMING AN ACADEMIC, AND WITH A MORE MODEST TIME COMMITMENT SINCE, I HAVE PRACTICED LAW PRIMARILY IN THE FEDERAL TAX FIELD.

THE COMMITTEE IS TODAY CONSIDERING SOME VERY IMPORTANT CHANGES IN SUBCHAPTER C, THE CORPORATE TAX PROVISIONS OF THE INTERNAL REVENUE CODE. THESE CHANGES DERIVE FROM A BILL, H.R. 6295, INTRODUCED IN THE HOUSE THIS SPRING BY REPRESENTATIVE STARK AND, MORE CLOSELY AND DIRECTLY, FROM S. 2687, A REVISION INTRODUCED TWO WEEKS AGO BY SENATOR DANFORTH. MR. STARK'S GERMINAL BILL WAS THE SUBJECT OF A SUBCOMMITTEE HEARING IN THE HOUSE ON MAY 24 BUT HAS NOT TO DATE BEEN ACTED ON BY THE HOUSE. ALTHOUGH THE FINANCE COMMITTEE IN THE DEFICIT REDUCTION PACKAGE HAS EMBRACED THE MORE RECENT VERSION OF THE BILL, THIS MORNING MARKS THE COMMITTEE'S FIRST OPPORTUNITY TO REVIEW THE PROPOSED CHANGES WITH CARE AND IN DETAIL.

THE BURDEN OF MY TESTIMONY THIS MORNING IS TWOFOLD.

FIRST, I BELIEVE THE LEGISLATION REACTS EFFECTIVELY TO SOME SIGNIFICANT ABUSES UNDER PRESENT LAW. THE THREE SPECIFIC CHANGES PROPOSED -- THE REPEAL OF PORTIONS OF SECTION 311(D)(2), THE REPEAL OF PRESENT SECTION 346(A)(2) AND (B) RELATING TO PARTIAL LIQUIDATIONS AND INSERTION OF NEW SECTION 302(E) FOR NON-CORPORATE DISTRIBUTEES, AND THE REPLACEMENT OF THE SECTION 334(B)(2) LIQUIDATION REQUIREMENT BY A NEW SECTION 338 ELECTION TIED DIRECTLY TO THE SECTION 337 MECHANISM -- ARE APPROPRIATE AND OVERDUE.

SECOND, THE BILL'S GENERAL CONDEMNATION OF SELECTIVE ELECTIVITY, THE PURCHASER'S ABILITY UNDER PRESENT LAW TO STEP-UP THE BASIS OF THE ASSETS OF ONE BUT NOT ALL OF THE CORPORATIONS IN AN ACQUIRED CORPORATE GROUP, SEEMS TO ME BOTH UNSOUND AND UNWORKABLE. IT IS UNSOUND BECAUSE IT SIDESTEPS THE REAL PROBLEM -- THE SO-CALLED GENERAL UTILITIES DOCTRINE -- AND BECAUSE, TO THE EXTENT REFORM ASPIRATIONS FALL SHORT OF DEALING SQUARELY WITH CORE PROBLEMS, OTHER PROVISIONS OF THE BILL ALREADY PROVIDE FAR LESS DISRUPTIVE WAYS TO DEAL WITH THE PERCEIVED ABUSE. THE BILL'S CONDEMNATORY APPROACH TO SELECTIVE ELECTIVITY IS UNWORKABLE, IN MY VIEW, BECAUSE THE SOPHISTICATED CORPORATE TAX BAR, RETAINED BY ACQUIRING CORPORATIONS ABLE TO AFFORD THESE FOLK, WILL TURN THE STATUTORY SCHEME INTO AN AVOIDABLE NUISANCE, LEAVING BEHIND A GIANT TRAP FOR THE LESS AFFLUENT.

IN SUM, I BELIEVE THE BILL PROPOSES THREE SPECIFIC CHANGES IN SUBCHAPTER C THAT ARE SOUND, SIMPLIFYING, AND IMPORTANT, AND ONE

GENERAL CHANGE THAT IS UNSOUND, COMPLICATING, UNWORKABLE, AND IMPORTANT. I SHOULD LIKE TO ADDRESS A FEW TECHNICAL COMMENTS TO THE THREE SPECIFIC CHANGES PROPOSED, AND THEN CONSIDER THE BILL'S GENERAL PROPOSAL TO CONDEMN SELECTIVELY ELECTIVE ASSET BASIS STEP-UP IN CORPORATE ACQUISITIONS.

I. THREE SPECIFIC CHANGES IN PRESENT LAW

IN THE MAIN, THE GENESIS OF THE SPECIFIC CHANGES PROPOSED IN PRESENT LAW ARE SOME RATHER WELL PUBLICIZED RECENT CORPORATE ACQUISITIONS IN WHICH THE TAX TREATMENT SOUGHT, AND IN A NUMBER OF CASES CLEARLY OBTAINED, BY THE PURCHASING CORPORATION OR CORPORATE GROUP -- I WILL FROM TIME TO TIME REFER TO P CORPORATION, ITS SUBSIDIARY S CORPORATION, AND THE TWO OF THEM AND ANY OTHER MEMBERS COLLECTIVELY AS THE P AFFILIATED GROUP -- SEEMS EXCESSIVELY FAVORABLE, FAR BEYOND WHAT A RATIONALE CONGRESS COULD HAVE ANTICIPATED. I READILY ADMIT TO SHARING THAT VIEW.

A. SECTION 311(D)(2)

THE BILL PROPOSES TO REPEAL PARAGRAPH (A), (B), (C), AND (G) OF SECTION 311(D)(2), AND THEREBY TO REQUIRE THAT A CORPORATION DISTRIBUTING APPRECIATED PROPERTY IN REDEMPTION OF PART OF ITS STOCK, OTHER THAN AS PART OF A COMPLETE LIQUIDATION OR A SECTION 355 SPLIT-OFF OR SPLIT-UP, RECOGNIZE THE ENTIRE GAIN (AND NOT MERELY "RECAPTURE" INCOME) INHERENT IN THOSE ASSETS. THIS SEEMS TO ME ENTIRELY SENSIBLE. THE NOTION THAT A CORPORATION DOES NOT RECOGNIZE GAIN ON THE DISTRIBUTION OF APPRECIATED PROPERTY TO ITS SHAREHOLDERS, THE GENERAL UTILITIES DOCTRINE, HAS BEEN SIGNIFI-

CANTLY AND RATHER STEADILY ERODED BY CONGRESSIONAL ENACTMENTS AND COURT DECISIONS OVER THE PAST TWENTY-EIGHT YEARS. THE DOCTRINE HAS PRODUCED MUCH MISCHIEF AND TRANSACTIONAL COMPLEXITY IN TAX PRACTICE, AND THE PROPOSAL FURTHER TO CIRCUMSCRIBE IT IS IN THE RIGHT DIRECTION.

THERE IS, HOWEVER, A TECHNICAL PROBLEM IN THE INTERRELATIONSHIP OF THE REVISION OF SECTION 311(D)(2) AND THE ENACTMENT OF PROPOSED SECTION 338. I WILL DESCRIBE IT IN REVIEWING THE LATTER PROVISION.

B. SECTION 346

THE BILL PROPOSES TO PRESERVE SECTION 346(A)(1) (PARTIAL LIQUIDATING DISTRIBUTIONS THAT ARE PART OF A COMPLETE LIQUIDATION), TO REPEAL THE BALANCE OF PRESENT SECTION 346 (DISTRIBUTION OF THE ASSETS OR PROCEEDS OF SALE OF A QUALIFIED TRADE OR BUSINESS AND DISTRIBUTION INCIDENT TO A "CORPORATE CONTRACTION"), AND TO INSERT A PROTECTIVE "TRANSACTIONS WHICH MIGHT REACH THE SAME RESULT AS PARTIAL LIQUIDATIONS" GRANT TO THE TREASURY OF LEGISLATIVE AUTHORITY TO WRITE REGULATIONS. THE BILL ALSO PROPOSES A NEW SECTION 302(E), UNDER WHICH A SHAREHOLDER WHO IS NOT A CORPORATION WILL BE AWARDED SALE (RATHER THAN DIVIDEND) TREATMENT WHEN A STOCK REDEMPTION IS ATTRIBUTABLE TO THE SORT OF "OLD LAW" PARTIAL LIQUIDATION DESCRIBED IN PRESENT SECTION 346(B).

THE PROPOSED REPEAL OF PRESENT SECTIONS 346(A)(2) AND 346(B), AND THE DETERMINATION NOT TO EXTEND PROPOSED SECTION 302(E) TO CORPORATE SHAREHOLDERS, ARE SOUND AND SENSIBLE. AMONG OTHER

THINGS, THE ENACTMENT OF THESE RULES WILL PUT AN END TO WHAT HAS BEEN PERHAPS THE MOST SERIOUS ABUSE UNDER CURRENT LAW, THE WHOLLY TAX AVOIDING BASIS STEP-UP PARTIAL LIQUIDATION OF A RECENTLY PURCHASED CORPORATION INSIDE THE BUYER'S CONSOLIDATED FEDERAL TAX RETURN.

THE EXTREMELY BROAD GRANT OF REGULATORY AUTHORITY, PROPOSED NEW SECTION 346(B), IS COMPREHENSIBLE BUT TROUBLESOME IN GENERATING POTENTIALLY GREAT UNCERTAINTY. IT WOULD BE EXTREMELY HELPFUL IF THE COMMITTEE REPORT WERE TO IDENTIFY THE SORT OF CONCERNS THAT UNDERLY THE GRANT AND SUPPLY SOME GUIDANCE FOR THE BENEFIT OF THE TREASURY AND THE PRIVATE SECTOR.

AGAIN, THERE APPEARS TO BE A TECHNICAL PROBLEM IN THE INTERACTION OF THE CHANGES TO SECTION 346 AND THE ENACTMENT OF NEW SECTION 338, AND AGAIN I WILL REFER TO IT FURTHER IN CONSIDERING THE LATTER PROVISION.

C. NEW SECTION 338

THE BILL PROPOSES TO ELIMINATE THE CORPORATE MECHANIC OF A SECTION 334(B)(2) LIQUIDATION, WHEN THE CONTROLLING STOCK OF TARGET CORPORATION HAS BEEN RECENTLY PURCHASED BY UNRELATED P CORPORATION, AND TO SUBSTITUTE A SIMPLE ELECTION. PURSUANT TO THAT ELECTION, TARGET WILL BE TREATED AS HAVING SOLD ALL OF ITS ASSETS TO AN UNRELATED CORPORATION IN A TRANSACTION GOVERNED BY SECTION 337. SETTING ASIDE FOR THE MOMENT THE SELECTIVE ELECTIVITY ISSUE, I BELIEVE THIS PROPOSED CHANGE WILL YIELD MAJOR BENEFITS IN TAX SIMPLIFICATION AND TAX RATIONALITY, AND I ENDORSE IT STRONGLY.

THE PROPOSAL SEEKS TO PLACE ALL TAXABLE CORPORATE ACQUISITIONS UNDER A UNIFORM TAXING REGIME. SECTION 337, WHICH NOW GOVERNS ONLY ASSET SALE TRANSACTIONS, WILL GOVERN THE STOCK ACQUISITION TRANSACTION AS WELL. THE BENEFIT TO TAXPAYERS AND THE TAXING SYSTEM WILL BE ENORMOUS IN ELIMINATING MANY OF THE DISCONTINUITIES THAT CURRENTLY INHERE IN THE TAX TREATMENT UNDER SECTION 337 AND THE TAX TREATMENT UNDER SECTION 334(B)(2).

WHILE THIS COORDINATION OF TAX RULES IS INEVITABLY SOUND AND SIMPLIFYING, THERE ARE TECHNICAL PROBLEMS THAT DESERVE ATTENTION. THE FOLLOWING COMMENTS REACT TO S. 2687 IN THE FORM IN WHICH IT APPEARED IN THE CONGRESSIONAL RECORD FOR JUNE 29, 1982.

1. IDENTITY OF PURCHASER

THE BILL LIMITS THE BENEFITS OF THE NEW ELECTION SYSTEM TO TRANSACTIONS IN WHICH THE CONTROLLING STOCK OF TARGET CORPORATION HAS BEEN PURCHASED BY A SINGLE CORPORATION, OR, UNDER PROPOSED SECTION 338(G)(7), BY MEMBERS OF AN AFFILIATED GROUP OF CORPORATIONS. THERE IS NO REASON TO LIMIT SECTION 338 IN THIS WAY, OTHER THAN AS PART OF THE UNFORTUNATE ANTI-SELECTIVITY, "ALL-OR-NOTHING" APPROACH NOW INCORPORATED IN THE PROPOSED PROVISION.

IF, AS URGED, THE ALL-OR-NOTHING APPROACH IS DROPPED, THE BENEFIT OF A SECTION 338 ELECTION SHOULD BE AVAILABLE WHEN, WITHIN THE STATUTORY TWELVE MONTH PERIOD, CONTROL OF TARGET IS PURCHASED BY A PARTNERSHIP OR A TRUST OR AN INDIVIDUAL OR A GROUP OF INDIVIDUALS ACTING IN CONCERT OR, I SUGGEST, BY VARIOUS PEOPLE WHETHER OR NOT ACTING IN CONCERT. THE ELECTIVE SYSTEM IS HIGHLY

SALUTARY IN ELIMINATING THE PRESENT LAW REQUIREMENT THAT WHAT IS SIMPLY A TAX ELECTION BE MADE THROUGH THE CORPORATE MECHANIC OF A LIQUIDATION. IT IS EQUALLY SENSIBLE, AND MORE CONSISTENT WITH THE BILL'S GENERAL APPROACH, TO ALLOW THE ELECTION TO BE MADE WHENEVER CONTROL IS PURCHASED WITHIN THE STATUTORILY DESIGNATED TIME, AND THEREBY AVOID FORCING A NONCORPORATE BUYER TO DANCE A MEANINGLESS MINUET: ORGANIZE A DUMMY CORPORATION SOLELY TO EFFECT THE PURCHASE, FILE THE SECTION 338 ELECTION, AND THEN EITHER LIQUIDATE OR MERGE DOWNSTREAM INTO THE TARGET CORPORATION.

2. THE ELECTING CORPORATION

THE BILL PROPOSES THAT THE ELECTION TO STEP-UP ASSET BASIS (AND TRIGGER RECAPTURES) BE MADE BY P, THE PURCHASING CORPORATION, WITHIN 75 DAYS AFTER THE ACQUISITION DATE (THE DATE ON WHICH 80 PERCENT CONTROL OF TARGET CORPORATION IS ACQUIRED). I WOULD URGE THAT THE ELECTION SHOULD BE MADE BY TARGET CORPORATION RATHER THAN BY P, THE PURCHASING CORPORATION. OBVIOUSLY THIS WILL BE APPROPRIATE IF, AS RECOMMENDED ABOVE, PROPOSED SECTION 338 IS AMENDED TO ENCOMPASS STOCK PURCHASES BY A PERSON OR PERSONS OTHER THAN A SINGLE CORPORATION OR CORPORATE GROUP. MORE GENERALLY, ELECTION BY TARGET CORPORATION ITSELF WILL AVOID ALL MANNER OF POTENTIAL CONFUSION IF, FOR EXAMPLE, WITHIN THE 75 DAYS AND BEFORE ELECTION IS FILED P, BY DISTRIBUTION OR SALE OR CONTRIBUTION OR MERGER OR FORECLOSURE OR IN ANY OTHER MANNER, TRANSFERS THE STOCK OF TARGET CORPORATION. ALTHOUGH NOT CRYSTAL CLEAR IN THE BILL, IT SEEMS TO BE -- AND CERTAINLY IT OUGHT TO BE -- THE LEGISLATIVE

INTENT THAT, ONCE THERE HAS BEEN A QUALIFIED STOCK PURCHASE (PURCHASE OF THE CONTROLLING STOCK) OF TARGET AN ABSOLUTE RIGHT TO ELECT WITHIN 75 DAYS UNDER SECTION 338 ACCRUES. A CONTRARY APPROACH, ONE THAT WOULD EXPUNGE THE RIGHT TO ELECT IF, FOR EXAMPLE, P CONTRIBUTES TO ITS SUBSIDIARY S OR DISTRIBUTES TO P'S OWN SHAREHOLDER MORE THAN 20% OF THE STOCK OF TARGET, WOULD RESURRECT SOME OF THE LARGER TRAPS AND MISFORTUNES OF PRESENT LAW, TRAPS AND MISFORTUNES THE REPEAL OF SECTION 334(B)(2) AND THE ENACTMENT OF ELECTIVE SECTION 338 SHOULD BE DESIGNED TO ELIMINATE. DESIGNATING TARGET RATHER THAN THE PURCHASER AS THE PROPER ELECTING PERSON PROVIDES A CLEAN AND UNCOMPLICATED WAY TO AVOID THAT HOST OF PROBLEMS.

3. ASSET BASIS: IN GENERAL

PROPOSED SECTION 338(B) TREATS THE ASSETS OF TARGET CORPORATION AS HAVING BEEN SOLD (AND PURCHASED) AT AN AMOUNT EQUAL TO THE BASIS OF P'S STOCK IN TARGET ON WHICHEVER OF THE FOLLOWING DAYS SUCH BASIS IS GREATER -- THE ACQUISITION DATE OR THE LAST DAY OF THE 12-MONTH ACQUISITION PERIOD -- PLUS A PROPER ADJUSTMENT (UNDER REGULATIONS TO BE ISSUED) FOR LIABILITIES OF THE TARGET CORPORATION "AND OTHER RELEVANT ITEMS." THE IMPORT OF THIS STATUTORY RECIPE IS LESS THAN WHOLLY CLEAR, BUT IT SEEMS TO PROVIDE A NUMBER OF DOUBTFUL ANSWERS.

ASSUME THAT ON JANUARY 1, 1983 P PURCHASES FOR 200 ALL OF THE STOCK OF TARGET CORPORATION. TARGET HAS NO LIABILITIES

AND A SINGLE ASSET, A MILLING MACHINE WITH THESE TAX CHARACTERISTICS: VALUE 300, ADJUSTED BASIS 140, RECAPTURABLE DEPRECIATION 160 (ASSUME A 50% CORPORATE TAX RATE AND RESULTING RECAPTURE TAX POTENTIAL OF 80), AND RECAPTURABLE INVESTMENT CREDIT TAX OF 20. IF WE ASSUME, AS WE MUST TO MAKE SENSE OUT OF THE STATUTE, THAT THE TARGET CORPORATION LIABILITIES FOR WHICH THE REGULATIONS WILL PROVIDE PROPER ADJUSTMENT INCLUDE THE 80 OF DEPRECIATION RECAPTURE TAX AND 20 OF INVESTMENT CREDIT RECAPTURE TAX TRIGGERED UPON THE SECTION 338 ELECTION, WE WILL REACH THE CORRECT ANSWER THAT, IN THE HANDS OF TARGET CORPORATION POST-ELECTION, THE MACHINE HAS A BASIS OF 300. THAT AMOUNT, AFTER ALL, IS WHAT P WILL PAY IN TOTAL, 200 FOR THE TARGET STOCK AND 100 TO DEFRAY THE RECAPTURE TAXES.

ASSUME P DEFRAYS THOSE COSTS BY CONTRIBUTING 100 TO THE CAPITAL OF TARGET CORPORATION, ITS NOW WHOLLY-OWNED SUBSIDIARY. AT THE CLOSE OF 1983, THE LAST DAY OF THE 12-MONTH ACQUISITION PERIOD, P'S BASIS IN THE TARGET SHARES WILL INCLUDE THE CONTRIBUTED 100. UNDER ONE "LITERAL" READING OF PROPOSED SECTION 338(B), TARGET'S BASIS IN THE MACHINE WILL BE STEPPED-UP TO 400, EQUAL TO P'S 300 BASIS IN THE TARGET STOCK PLUS THE RECAPTURE TAX LIABILITIES OF 100. THAT MAKES NO SENSE.

ASSUME THAT P IS FILING A CONSOLIDATED RETURN AND "NEW" TARGET IS INCLUDED IN THAT RETURN COMMENCING IMMEDIATELY AFTER THE EFFECTIVE TIME OF THE BASIS STEP-UP. IN 1983 "NEW" TARGET CORPORATION OPERATES PROFITABLY AND GENERATES NET INCOME OF 30.

UNDER THE CONSOLIDATED RETURN REGULATIONS P'S BASIS IN THE STOCK OF TARGET IS INCREASED BY THAT 30. UNDER ONE READING OF PROPOSED SECTION 338(B) THE BASIS OF THE MACHINE IN THE HANDS OF TARGET ALSO IS INCREASED BY 30. THAT MAKES NO SENSE EITHER.

ASSUME INSTEAD THAT P DID NOT PURCHASE THE STOCK OF TARGET FOR A FIXED PRICE OF 200. RATHER, THE SELLER OF THE STOCK AND P WERE OF DIFFERENT VIEWS AS TO THE VALUE OF TARGET AND AGREED TO AN INITIAL PURCHASE PRICE OF 200 AND A CONTINGENT ADDITIONAL PURCHASE PRICE, PAYABLE AT THE CLOSE OF 1984, BASED UPON A FORMULA KEYED TO THE PROFITS OR PRODUCTIVITY OF TARGET. AT THE CLOSE OF 1984 P PROPERLY PAYS THE SELLER AN ADDITIONAL 100 PLUS ADEQUATE INTEREST. IF P HAD PURCHASED THE ASSETS RATHER THAN THE STOCK OF TARGET, WITHOUT QUESTION THE ADDITIONAL 100, WHEN DETERMINED, WOULD BE ADDED TO THE BASIS OF THE APPROPRIATE ASSET OR ASSETS EARLIER PURCHASED. THE RESULT OUGHT TO BE THE SAME UNDER SECTION 338, AND TARGET OUGHT AS WELL BE RESPONSIBLE FOR ANY ADDITIONAL RECAPTURE TAXES, BUT THERE ARE PROBLEMS UNDER THE STATUTE AS DRAFTED. PROPOSED SECTION 338(B)(2) CONTEMPLATES A HYPOTHETICAL ASSET SALE AND PURCHASE PRICE AT AN AMOUNT "PROPERLY ADJUSTED UNDER REGULATIONS" TO BE WRITTEN FOR LIABILITIES OF THE TARGET CORPORATION "AND OTHER RELEVANT ITEMS." CONTINGENT ADDITIONAL PURCHASE PRICE CERTAINLY SHOULD QUALIFY AS A "RELEVANT ITEM," AS SHOULD ANY SUBSEQUENTLY NEGOTIATED REDUCTION IN THE PURCHASE PRICE OF TARGET CORPORATION'S STOCK DUE, FOR EXAMPLE, TO A BREACH OF THE SELLER'S

WARRANTY. A DIFFICULTY IS THAT ANY RESULTING INCREASE IN OR REDUCTION OF RECAPTURED DEPRECIATION PROPERLY SHOULD NOT BE REFLECTED IN THE CONSOLIDATED RETURN THAT P WILL FILE AND THAT WILL INCLUDE TARGET CORPORATION IN 1984, THE PURCHASE PRICE ADJUSTMENT YEAR. A PRINCIPAL OBJECTIVE IN REPLACING SECTION 334(B)(2) WITH NEW SECTION 338 IS TO PREVENT THE OFFSETTING OF TARGET CORPORATION'S RECAPTURE INCOME BY ANY P CORPORATION CONSOLIDATED LOSS. THAT OBJECTIVE WILL BE UNDERCUT, AND SUBSTANTIALLY UNDERCUT THROUGH CAREFUL TRANSACTIONAL PLANNING, UNLESS THE REGULATIONS REQUIRE SEPARATE REPORTING OF SUBSEQUENTLY GENERATED RECAPTURE INCOME AND APPROPRIATELY TAILORED REFLECTION OF DOWNWARD PURCHASE PRICE ADJUSTMENTS. THE COMMITTEE REPORT OUGHT TO FURNISH THE APPROPRIATE GUIDANCE TO THE TREASURY.

4. ASSET BASIS; MINORITY INTERESTS

RETURN TO THE ORIGINAL EXAMPLE BUT ASSUME THAT, RATHER THAN PURCHASING ALL OF THE TARGET STOCK FOR 200, ON JANUARY 1, 1983 P PURCHASES 90% OF THE STOCK OF TARGET FOR 180, THE REMAINING 10% STANDING IN THE HANDS OF UNRELATED MRS. K, AND THE STEP-UP ELECTION UNDER SECTION 338 PROMPTLY IS MADE. WHAT IS THE IMPACT ON MRS. K, WHAT AMOUNT OF RECAPTURE TAX MUST TARGET PAY, AND AT WHAT BASIS WILL TARGET HOLD THE MACHINE?

UNDER PRESENT LAW, A SECTION 334(B)(2) LIQUIDATION OF TARGET IS A TAXABLE EVENT TO MRS. K. WHETHER SHE RECEIVES CASH OR P STOCK IN EXCHANGE FOR HER TARGET SHARES, MRS. K MUST RECOGNIZE

GAIN (OR LOSS) ON THE EXCHANGE. CONCOMITANTLY, UNDER PRESENT LAW, P IN PRACTICAL EFFECT IS TREATED AS HAVING PURCHASED HER TARGET SHARES FOR THE 20 IN VALUE MRS. K RECEIVES, AND THUS BOTH TARGET RECAPTURE TAXES AND POST-LIQUIDATION ASSET BASIS ARE DETERMINED IN A MANNER THAT REFLECTS A 200 PURCHASE PRICE FOR ALL OF THE SHARES OF TARGET.

THE CURRENT RULE UNDER WHICH MRS. K IS TAXED WHEN SHE RECEIVES NO CASH AND SIMPLY CONTINUES AS A SHAREHOLDER IN THE CORPORATE ENTERPRISE HAS BEEN WIDELY CRITIZED. ENACTMENT OF PROPOSED SECTION 338 AND CONSEQUENT ELIMINATION OF THE LIQUIDATION MECHANISM PROVIDES THE OPPORTUNITY TO AVOID A SUDDEN TAX TO MRS. K WHO, UNDER THE NEW REGIME, SIMPLY WILL CONTINUE TO HOLD HER TARGET SHARES. IT IS, AFTER ALL, A VERY BASIC NOTION IN OUR TAX LAW THAT INCOME, GAIN, OR LOSS IS NOT RECOGNIZED IN THE ABSENCE OF A TAXABLE "EVENT," A SALE OR EXCHANGE OR OTHER IDENTIFIABLE CHANGE IN THE POSITION OF THE PARTICULAR TAXPAYER. WHEN A CORPORATION SELLS ITS ASSETS BUT DOES NOT LIQUIDATE OR OTHERWISE DISTRIBUTE, WE DO NOT TAX THE SHAREHOLDERS BECAUSE, WHILE THE POSITION OF THE CORPORATION HAS ALTERED, THE SHAREHOLDERS HAVE NOT CHANGED THEIR POSITIONS. THIS POLICY IS SO STRONGLY EMBEDDED IN OUR TAX LAW THAT ONLY ONE DEPARTURE FROM IT, SECTION 368(A)(1)(F)(VI), READILY COMES TO MIND. THAT SECTION DEALS WITH AN IDENTIFIED ABUSE INVOLVING ALL OF THE SHAREHOLDERS OF A SPECIFIC KIND OF CORPORATION; CERTAINLY MRS. K ENGAGES IN NO IMPROPRIETY WHEN SHE DETERMINES TO RETAIN, OR INDEED IS NOT EVEN OFFERED THE OPPORTUNITY TO SELL, HER MINORITY INVESTMENT.

UNFORTUNATELY, WHATEVER APPROACH IS TAKEN WILL PRESENT SIGNIFICANT DIFFICULTIES. IF TARGET IS A CONTROLLED FOREIGN CORPORATION AND MRS. K A UNITED STATES SHAREHOLDER, EITHER SHE MUST BE TAXED AT THE TIME OF THE SECTION 338 ELECTION OR COMPLEX RULES MUST BE CRAFTED TO TAX HER ON THE APPROPRIATE QUANTUM OF ORDINARY INCOME WHEN SHE LATER SELLS SHARES. SETTING ASIDE THE SPECIAL PROBLEM OF A CONTROLLED FOREIGN CORPORATION, THE DETERMINATION NOT TO TAX MRS. K WHEN A SECTION 338 ELECTION IS MADE REQUIRES RESOLUTION OF TROUBLESOME CORPORATE LEVEL RECAPTURE, GAIN, AND BASIS ISSUES.

THOSE ISSUES ARE EXPLORED BELOW. AT THE OUTSET, HOWEVER, I NOTE THAT AS DRAFTED PROPOSED SECTION 338 DOES NOT CLEARLY ANNOUNCE WHETHER MRS. K IS OR IS NOT TREATED AS HAVING MADE A TAXABLE EXCHANGE OF HER TARGET SHARES WHEN A SECTION 338 ELECTION IS FILED. PRESUMABLY THE ANSWER IS, AS I BELIEVE IT OUGHT TO BE, THAT SHE IS NOT TAXED UPON THAT FILING. BUT SECTION 338(A)(2) STATES THAT, UPON THE ELECTION, TARGET "SHALL BE TREATED AS A NEW CORPORATION" AND SECTION 338(A) OPENS WITH THE ANNOUNCEMENT THAT ITS RULES APPLY "FOR PURPOSES OF THIS TITLE," THAT IS, FOR ALL INCOME TAX PURPOSES. AT THE LEAST, A CLARIFICATION WOULD SEEM IN ORDER.

ASSUME MRS. K RETAINS HER 10% THROUGHOUT 1983 AND THAT THE SECTION 338 ELECTION DID NOT TRIGGER TAXABLE GAIN TO HER. THE BILL REFERS US TO P'S BASIS IN THE STOCK (180) PLUS LIABILITIES OF TARGET CORPORATION WHICH, WE HAVE ASSUMED, INCLUDE RECAPTURE

TAXES. INVESTMENT CREDIT RECAPTURE TAX OF 20 IS CERTAIN IF WE MAY ASSUME TARGET IS TREATED AS HAVING SOLD THE ENTIRE MACHINE AND NOT MERELY 90% OF IT. BUT NOTHING ELSE IS CLEAR SINCE THE STATUTE AS DRAFTED FORCES US TO RUN IN A CIRCLE. THE AMOUNT OF DEPRECIATION RECAPTURE TAX IS DETERMINED BY THE HYPOTHETICAL SALE PRICE OF THE MACHINE, AND THAT HYPOTHETICAL PRICE, IN TURN, IS DETERMINED BY THE AMOUNT OF DEPRECIATION RECAPTURE TAX.

IN AN ERA THAT CRIES OUT FOR TAX SIMPLIFICATION, A REASONABLE CONGRESS OUGHT NOT WRITE A STATUTE THAT CONTAINS A FORMULA INCORPORATING TWO INTERDEPENDENT VARIABLES.

AND IT DOES NOT SEEM INAPPROPRIATE, AT THIS POINT, TO NOTE THAT WE ARE NOT HERE DEALING WITH MATTERS OF A FEW PERCENTAGE POINTS. IF MRS. K OWNED NONVOTING LIMITED PREFERRED STOCK OF TARGET WORTH 100, P ON JANUARY 1, 1983 WOULD HAVE PURCHASED THE COMMON STOCK OF TARGET FOR 100. HOW THE REGULATIONS ARE PROPERLY TO ADJUST DIFFERENCES OF THIS SORT, DIFFERENCES IN THE QUALITY OF STOCK OWNED AS WELL AS IN AMOUNTS PAID, MAY PROVE TO BE ONE OF THE GREATER REVELATIONS OF MODERN ADMINISTRATIVE PRACTICE. AND, WHATEVER MAY BE REVEALED, THE ADVERSE IMPACT ON THE REVENUE WILL BE UNAVOIDABLE: DEPRECIATION NOT RECAPTURED AT THE TIME OF THE SECTION 338 ELECTION GOES WAY, AND ON A LATER SALE OF THE PROPERTY -- PERHAPS 13 MONTHS LATER -- ORDINARY INCOME WILL HAVE BEEN TRANSMUTTED INTO LONG-TERM CAPITAL GAIN.

THERE IS, I BELIEVE, AN ACCEPTABLE WAY OUT OF THE SWAMP. THE STATUTE AS DRAFTED POINTS IN THE APPROPRIATE DIRECTION

IN REFERRING TO P'S BASIS IN THE TARGET STOCK ON THE LAST DAY OF THE 12-MONTH ACQUISITION PERIOD. THAT REFERENCE SEEMS TO MAKE SENSE ONLY IN THE CONTEXT OF A PURCHASE BY P, BEFORE THE CLOSE OF 1983, OF THE STOCK OF TARGET THAT MRS. K HAS RETAINED. THE UNDERLYING NOTION, A REASONABLE PERIOD AFTER ACQUISITION OF CONTROL IN WHICH TO COMPLETE THE TRANSACTION AND AVOID TAX DETRIMENT, OUGHT TO BE EMBRACED AS PART OF A LESS COMPLEX APPROACH.

ON JANUARY 1, 1983, WHEN P PURCHASES 90% OF TARGET AND A SECTION 338 ELECTION IS TIMELY MADE, THE HYPOTHETICAL ASSET SALE AND PURCHASE SHOULD BE AT FULL PRICE. IF ON JANUARY 1, 1983 P HAS PURCHASED 90 SHARES PAYING 180, THE FULL PURCHASE PRICE FOR ALL 100 SHARES OF TARGET CORPORATION IS 200. HYPOTHETICAL ASSET SALE AND PURCHASE PRICE SHOULD BE CALCULATED AT FULL PRICE, ESSENTIALLY FAIR MARKET VALUE WHEN P HAS BOUGHT ALL OF ITS TARGET SHARES IN A SINGLE QUALIFIED STOCK PURCHASE, WITH RECAPTURE TAXES IMPOSED AND BASIS DETERMINED ACCORDINGLY.

IN THE EXAMPLE CASE ALL APPRECIATION IN THE MACHINE WAS SUBJECT TO DEPRECIATION RECAPTURE. ASSUME INSTEAD THAT THE ONLY ASSET OF TARGET CORPORATION IS APPRECIATED INVESTMENT LAND, A CAPITAL ASSET, AND THAT THE LAND HAS A BASIS TO TARGET CORPORATION OF 100, A FAIR MARKET VALUE OF 300, AND IS SUBJECT TO A MORTGAGE OF 100. P PURCHASES 90% OF THE STOCK FOR 180 AND MRS. K RETAINS THE OTHER 10 PERCENT. IN THIS CASE A BASIS STEP-UP TO 300, RATHER THAN 280 OR 270 (DEPENDING UPON HOW THE REGULATIONS WOULD ADJUST

FOR LIABILITIES), MAY APPEAR TOO FAVORABLE. IF THIS IS DEEMED A SERIOUS CONCERN, A PALATABLE RESPONSE, I BELIEVE, IS TO PROVIDE THAT ON THE HYPOTHETICAL SALE BY TARGET CORPORATION OF ITS ASSETS, SECTION 337 WILL APPLY ONLY TO THAT PERCENTAGE OF THE APPRECIATION WHICH REFLECTS THE PERCENTAGE OF THE TOTAL FAIR MARKET VALUE OF ALL TARGET STOCK THAT IS OWNED BY P OR MEMBERS OF THE P AFFILIATED GROUP. IN THE EXAMPLE, P OWNS 90% AND HENCE 10% OF THE 200 TOTAL APPRECIATION IN TARGET'S INVESTMENT LAND WOULD BE TAXED. HOWEVER, IF WITHIN SOME STATUTORILY SPECIFIED TIME FOLLOWING THE ACQUISITION DATE -- PERHAPS 12 MONTHS RATHER THAN "THE LAST DAY OF THE 12-MONTH ACQUISITION PERIOD" WHICH IN A GIVEN CASE MAY BE ONLY A MATTER OF DAYS FOLLOWING THE ACQUISITION DATE -- P OR ANY MEMBER OF THE P GROUP (INCLUDING "NEW" TARGET CORPORATION) PURCHASES THE TARGET STOCK OWNED BY MRS. K, THE ADDITIONAL TAX BURDEN SHOULD BE REMITTED.

5. DEFINITION OF PURCHASE

PROPOSED SECTION 338(G)(3)(A) TRACKS PRESENT SECTION 334(B)(3) IN DEFINING THE TERM "PURCHASE." CLAUSE (III) OF BOTH PROPOSED AND PRESENT LAW IS DEFECTIVE IN ITS UNQUALIFIED REFERENCE TO SECTION 318(A). THE PROBLEM IS THE OPTION ATTRIBUTION RULE OF SECTION 318(A)(4). IF ON JULY 1, 1983 P OBTAINS AN OPTION TO PURCHASE THE STOCK OF TARGET CORPORATION FROM AN UNRELATED OWNER, P'S EXERCISE OF THAT OPTION IN AUGUST OF 1984 IS NOT A "QUALIFIED STOCK PURCHASE" UNDER PROPOSED SECTION 338(C)(3) AND TARGET CANNOT STEP-UP THE BASIS OF ITS ASSETS UNDER SECTION 338.

THIS IS A SENSELESS RULE BECAUSE, HAD P INSTEAD OBTAINED AN OPTION TO PURCHASE THE ASSETS OF UNRELATED TARGET CORPORATION, ON EXERCISE P WOULD HAVE OBTAINED THE ASSETS AT A STEP-UP BASIS AND TARGET, ADOPTING A PLAN OF LIQUIDATION ON OPTION EXERCISE DAY, WOULD HAVE ENJOYED THE BENEFITS OF SECTION 337.

IN ENACTING THE INSTALLMENT SALES REVISION ACT OF 1980, CONGRESS CORRECTLY RESOLVED EXACTLY THIS SORT OF PROBLEM BY INSERTING IN SECTION 453(F)(1), IMMEDIATELY FOLLOWING THE STATUTORY REFERENCE TO SECTION 318(A), THE PARENTHETICAL EXCEPTION "OTHER THAN PARAGRAPH (4) THEREOF." IT OUGHT TO DO THE SAME IN PROPOSED SECTION 338(G)(3)(A)(III).

6. INCLUSION OF TARGET IN CONSOLIDATED RETURNS

PROPOSED SECTION 338(A)(1) STATES THAT IF A SECTION 338 ELECTION IS TIMELY MADE, TARGET SHALL BE TREATED AS HAVING SOLD ALL OF ITS ASSETS "ON THE ACQUISITION DATE" IN A SINGLE TRANSACTION TO WHICH SECTION 337 APPLIES. AS EARLIER NOTED IT IS, OR CERTAINLY IT OUGHT TO BE, THE INTENT OF THE STATUTE THAT TARGET, WITH RESPECT TO THIS DEEMED SALE OF ASSETS, IS NOT INCLUDED IN P'S CONSOLIDATED RETURN. THE UNTOWARD TAX ADVANTAGE THUS ELIMINATED BECOMES CLEAR IF ONE CONSIDERS A P GROUP WITH A SIZABLE CONSOLIDATED NET OPERATING LOSS AND A TARGET CORPORATION THAT EITHER HAS SUBSTANTIAL RECAPTURE ITEMS OR HAS FILED A CONSENT UNDER SECTION 341(F)(2).

UNFORTUNATELY, THE STATUTORY REFERENCE TO A DEEMED SALE OF ASSETS "ON THE ACQUISITION DATE" DOES NOT NEGATE THE POSSIBILITY THAT TARGET CORPORATION, ON THAT DATE, WILL BE INCLUDED

IN P'S CONSOLIDATED RETURN. THE PRESENT POSITION OF THE INTERNAL REVENUE SERVICE APPEARS TO BE THAT TARGET WILL NOT BE INCLUDED IN THE P CONSOLIDATED RETURN UNTIL THE DAY FOLLOWING THE ACQUISITION DATE, SEE REV. RUL. 80-169, 1980-1 C.B. 188, BUT THAT WAS NOT ALWAYS THE SERVICE POSITION, SEE REV. RUL. 72-201, 1972-1 C.B. 271, REVOKED BY REV. RUL. 80-169, AND THERE HAS BEEN AND PERHAPS REMAINS SOME WONDERFUL CONFUSION WITH REGARD TO ACQUISITIONS MADE AT DIFFERENT TIMES OF THE DAY, COMPARE TAM 7904002 (CLOSING AT 2:00 P.M.) WITH TAM 7914004 (CLOSING AT 10:00 A.M.).

IT WOULD, AT THE LEAST, BE HELPFUL IF THE COMMITTEE REPORT, CONSISTENT WITH THE MOST RECENT SERVICE PUBLISHED RULING, WERE TO ANNOUNCE THAT ON THE ACQUISITION DATE TARGET IS NOT A MEMBER OF THE P AFFILIATED GROUP. IT ALSO WOULD BE HELPFUL IF THE COMMITTEE REPORT WERE TO CONFIRM -- OR DENY -- THAT, IF P HAS PURCHASED THE CONTROLLING STOCK OF TARGET CORPORATION FROM ANOTHER AFFILIATED GROUP OF CORPORATIONS FILING A CONSOLIDATED RETURN, THE DEEMED SALE OF ASSETS BY TARGET WILL BE REPORTABLE IN THAT OTHER GROUP'S CONSOLIDATED RETURN FOR THE TAXABLE YEAR THAT INCLUDES THE ACQUISITION DATE.

7. ZENZ TRANSACTIONS

ASSUME MR. A OWNS ALL OF THE STOCK (100 SHARES) OF TARGET CORPORATION. TARGET IS WORTH 1,000. IT CONDUCTS A WIDGET BUSINESS WORTH 500, HOLDS A TRACT OF APPRECIATED INVESTMENT LAND WORTH 250, AND FOR MANY YEARS HAS HELD ALL OF THE STOCK OF X CORPORATION WHICH OPERATES A HOTEL AND IS WORTH 250. ASSUME THAT

P WISHES TO ACQUIRE THE WIDGET BUSINESS AND THE HOTEL AND A WISHES TO OWN THE INVESTMENT LAND.

TARGET AND ITS SUBSIDIARY X CORPORATION EACH MAY ADOPT A PLAN OF COMPLETE LIQUIDATION, RESPECTIVELY SELL THE WIDGET BUSINESS AND THE HOTEL TO P, AND THEN LIQUIDATE DISTRIBUTING TO A THE PROCEEDS OF THE SALES AND THE INVESTMENT LAND. UNDER SECTIONS 336 AND 337, THE CORPORATIONS WILL RECOGNIZE ONLY RECAPTURE INCOME ON THE SALES AND NO CORPORATE LEVEL GAIN WILL BE RECOGNIZED ON THE INVESTMENT LAND. THE BILL DOES NOT PROPOSE TO CHANGE THESE RESULTS.

UNDER PRESENT LAW A MAY SELL 75 OF HIS 100 TARGET CORPORATION SHARES TO P AND SIMULTANEOUSLY CAUSE TARGET TO REDEEM HIS REMAINING 25 SHARES IN EXCHANGE FOR THE INVESTMENT LAND. UNDER SECTION 311(D)(2)(A) TARGET WILL RECOGNIZE NO GAIN ON THAT REDEMPTION SINCE A HAS OWNED 10% OF TARGET MORE THAN 1 YEAR AND HIS INTEREST IN TARGET IS COMPLETELY TERMINATED. UNDER PRESENT LAW SIMILAR CORPORATE LEVEL NONRECOGNITION RESULTS WOULD OBTAIN, UNDER SECTION 311(D)(2)(B) OR SECTION 346(A)(2), IF THE STOCK OR ASSETS OF THE HOTEL SUBSIDIARY CORPORATION WERE SIMILARLY DISTRIBUTED IN A TERMINATING TRANSACTION, AND THIS WOULD BE SO EVEN IF A WERE A GROUP OF INDIVIDUALS NONE OF WHOM OWNS 10% OF THE STOCK OF TARGET.

THE BILL WOULD CHANGE THESE RESULTS. IN EACH OF THESE SO-CALLED ZENZ TRANSACTIONS -- A COMBINED SALE AND REDEMPTION OF ALL OF THE STOCK OF TARGET -- THE BILL WOULD TAX AT THE TARGET CORPORATION LEVEL ALL APPRECIATION, AND NOT MERELY RECAPTURE GAIN, INHERENT IN ASSETS DISTRIBUTED TO A.

THIS IS THE APPROPRIATE RESULT IN A ZENZ TRANSACTION IF THE OVERALL TRANSACTION IS ENGINEERED TO AVOID THE TRIGGERING OF RECAPTURE WITH RESPECT TO TARGET'S WIDGET BUSINESS. IT IS, HOWEVER, AN EXORBITANT RESPONSE IF THE WIDGET BUSINESS RECAPTURES ARE TRIGGERED AND THE ATTENDENT CORPORATE TAX PAID.

THE RESPONSE IS INAPPROPRIATE, IN THAT CIRCUMSTANCE, BECAUSE THE STATUTORY SCHEME IMPROPERLY INTRUDES UPON THE COMMERCIAL TRANSACTION, REWARDING TAXPAYERS ABLE TO OBTAIN BETTER TAX ADVICE WHILE SENSELESSLY PENALIZING TAXPAYERS WHO DO NOT HAVE ACCESS TO THAT LEVEL OF ADVICE. CONGRESS DEMONSTRATED A LAUDIBLE SENSITIVITY TO THIS SORT OF PROBLEM, AND ENACTED EXCELLENT LEGISLATION RESPONSIVE TO IT, IN THE INSTALLMENT SALES REVISION ACT OF 1980. IT WOULD BE UNFORTUNATE INDEED IF CONGRESS WERE NOW TO REVERSE FIELD AND RECREATE THE VERY SORT OF COMPLEX, ENTRAPPING TAX LEGISLATION IT SUCCEEDED IN ELIMINATING ONLY TWO YEARS AGO.

THE POINT CAN BE ILLUSTRATED THROUGH A COUPLE OF EXAMPLES.

IF MR. A CAUSES TARGET CORPORATION, WHEN WHOLLY-OWNED BY HIM, TO ADOPT A PLAN OF COMPLETE LIQUIDATION UNDER SECTION 331, THE DISTRIBUTION TO HIM OF THE INVESTMENT LAND (OR THE STOCK OF X CORPORATION) IN EXCHANGE FOR 25 OF HIS TARGET SHARES, FOLLOWED BY HIS SALE OF THE OTHER 75 SHARES TO P CORPORATION AND THE COMPLETION OF THE LIQUIDATION IN FAVOR OF P, AVOIDS THE CORPORATE LEVEL RECOGNITION PROBLEM. BECAUSE A PLAN OF COMPLETE LIQUIDATION HAS BEEN ADOPTED, SECTION 336 RATHER THAN SECTION 311(D)(1) IS IN POINT.

ALTERNATIVELY, A MAY SELL ALL OF HIS TARGET CORPORATION SHARES TO P. TARGET THEN MAY SELL THE INVESTMENT LAND TO A FOR 25 PERCENT OF THE CASH HE HAS RECEIVED FROM P. THE TIMELY FILING OF A SECTION 338 ELECTION WILL STEP-UP THE BASIS OF THE INVESTMENT LAND TO TARGET, AT NO CORPORATE LEVEL TAX COST, AND TARGET WILL RECOGNIZE NO GAIN ON THE SALE TO A.

THE IMPORTANT, SIMPLIFYING OBJECTIVE IN LEGISLATING IN THIS AREA OF SUBCHAPTER C IS TO EQUATE, AS NEARLY AS POSSIBLE, THE TAX RESULTS IN AN ASSET TRANSACTION (SECTIONS 336 AND 337) AND IN A STOCK TRANSACTION (SECTIONS 336 AND NEW 338). THE BILL MOVES IN THIS DIRECTION IN IMPORTANT WAYS, BUT IT COMPLICATES RATHER THAN SIMPLIFIES BY ALTERING THE TARGET CORPORATION TAX WHEN ECONOMICALLY IDENTICAL TRANSACTIONS ARE CRAFTED IN ONE WAY RATHER THAN ANOTHER.

I WOULD RECOMMEND, THEREFORE, THAT IN A _ZENZ_ TRANSACTION IN WHICH A SECTION 338 ELECTION IS TIMELY FILED FOR THE TARGET CORPORATION, THE BILL BE AMENDED TO PROVIDE THAT A REDEMPTION OF STOCK FROM MR. A THAT IS PART OF THE ACQUISITION PLAN SHOULD BE GOVERNED, AT THE TARGET CORPORATION LEVEL, BY SECTION 336 RATHER THAN BY SECTION 311. THE COMMITTEE REPORT SHOULD CONFIRM THAT A SECTION 338 ELECTION CAN BE FILED WHEN P "BACKS-IN" TO CONTROL OF TARGET IN THIS WAY.

II. Selective Electivity

As drafted, section 338 condemns selective electivity: To step-up the basis of any of the assets of target or a target affiliate, with but two exceptions P must step-up the basis of all of the assets of target and of every target affiliate the controlling stock of which P has purchased. The price of step-up is, of course, the incurring of liability for recapture taxes in all of these corporations. The all-or-nothing rule applies whether assets of target have been purchased or the controlling stock of target has been purchased and a section 338 election made; the two exceptions apply to an asset acquisition pursuant to a sale by target (or its affiliate) in the ordinary course of business, and to an asset acquisition in which basis carries over from the transferor.

It is useful to explore the conceptual and practical soundness of the proposal in concrete terms. Let us assume there are two corporations, H and W, the stock or assets of which P wishes to acquire. H owns and profitably operates a hotel. Depreciation has been taken on the straight line and, while the property is worth substantially in excess of its basis to H, recapturable depreciation and investment credit are minor. W owns and profitably operates a widget manufacturing business. Plant and equipment are worth substantially in excess of basis and recapturable depreciation and investment credit are very large. Well-advised, P looks

TO STEP-UP THE BASIS OF THE H ASSETS BUT, IN LIGHT OF EXCESSIVE RECAPTURE COSTS, DOES NOT WISH TO STEP-UP THE BASIS OF THE W ASSETS. UNDER PRESENT LAW, P CAN ACCOMPLISH THE DESIRED RESULTS WHETHER H AND W ARE OR ARE NOT AFFILIATED CORPORATIONS.

THE BILL PROPOSES TO ALTER THIS CONCLUSION, BUT ONLY IN PART.

IF H AND W ARE UNRELATED CORPORATIONS, THE BILL DOES NOT CHANGE THE RESULTS THAT OBTAIN UNDER PRESENT LAW. P CAN PURCHASE THE STOCK OF W, MAKE NO SECTION 338 ELECTION, AND AVOID RECAPTURE TAXES. P CAN PURCHASE THE ASSETS OF H, OR THE STOCK OF H AND FILE A SECTION 338 ELECTION, IN EITHER CASE OBTAINING FOR THE H ASSETS A STEPPED-UP BASIS AT THE LOW COST OF H'S MINOR RECAPTURE TAXES.

IF ALL OF THE STOCK OF H AND W IS OWNED BY A SINGLE INDIVIDUAL OR A PARTNERSHIP, THE RESULT IS EXACTLY THE SAME UNDER THE BILL. P MAY PURCHASE THE STOCK OF BOTH COMPANIES AND ELECT TO STEP-UP THE BASIS OF H'S HOTEL PROPERTY BUT NOT THE BASIS OF W'S INDUSTRIAL PROPERTY. THE BILL IS INDIFFERENT TO NON-CORPORATE AFFILIATION.

NEW SECTION 338 COMES INTO PLAY IF AND ONLY IF H AND W ARE AFFILIATED THROUGH CORPORATE LEVEL STOCK OWNERSHIP. IF H OWNS W OR W OWNS H, OR IF THE CONTROLLING STOCK OF BOTH W AND H IS OWNED BY A THIRD CORPORATION -- I WILL HEREAFTER REFER TO THE PARENT HOLDING CORPORATION OF H AND W AS T CORPORATION -- THE BILL DECLARES THAT P CANNOT STEP-UP THE BASIS OF H'S HOTEL UNLESS P IS PREPARED ALSO TO STEP-UP THE BASIS OF W'S INDUSTRIAL PROPERTY AND TRIGGER ALL OF W'S RECAPTURE TAXES.

A. CONCEPTUAL ANALYSIS

IT IS QUITE SENSIBLE TO ASSERT THAT, AS THE PRICE OF STEPPING-UP THE BASIS OF H'S HOTEL, H OUGHT TO INCUR A TAX LIABILITY APPROPRIATELY REFLECTIVE OF THE DIFFERENCE BETWEEN THE VALUE OF THE PROPERTY AND ITS BASIS IN H'S HANDS. BUT IT MAKES NO OBVIOUS SENSE TO DECLARE THAT, AS THE PRICE OF STEPPING-UP H'S HOTEL PROPERTY BASIS, TAX MUST BE PAID TO RECAPTURE DEPRECIATION DEDUCTIONS AND INVESTMENT CREDIT TAKEN BY W CORPORATION ON ITS OWN ASSETS OVER THE PAST YEARS.

WHY, THEN, DOES THE BILL PROPOSE TO TAX W AS THE PRICE OF GRANTING A STEPPED-UP ASSET BASIS TO H, AND WHY DOES IT PROPOSE TO DO THIS IF H AND W HAVE BEEN PURCHASED FROM T CORPORATION BUT NOT IF H AND W HAVE BEEN PURCHASED FROM A NON-CORPORATE OWNER?

THERE ARE, I THINK, TWO POSSIBLE ANSWERS. NEITHER SEEMS AT ALL SATISFACTORY.

FIRST, THE BILL IS A REACTION TO SOME SIGNIFICANT, RECENTLY PERCEIVED ABUSES OF PRESENT LAW. PARTICULAR FORMS OF SELECTIVE ELECTIVITY WERE IMPLICATED IN MANY OF THESE UNACCEPTABLE ARRANGEMENTS. THE SPECIFIC CHANGES IN SUBCHAPTER C PROPOSED IN THE BILL, EARLIER REVIEWED AND APPROVED IN PART I OF THIS TESTIMONY, RESPOND VERY EFFECTIVELY TO THE IDENTIFIED ABUSES. THE ANTI-SELECTIVITY, ALL-OR-NOTHING, APPROACH OF PROPOSED SECTION 338 IS SOMETHING OF A RESIDUAL BASKET. IT IS INTENDED TO CATCH WHATEVER REMAINS. IN THAT SENSE, IT SHOULD BE EVALUATED IN TERMS OF ITS ADHERENCE TO AND ITS DEPARTURE FROM NOTIONS OF SOUND CORPORATE TAX

POLICY, AND IT OUGHT AS WELL BE EVALUATED IN TERMS OF THE PRACTICAL QUESTION, WILL IT ACCOMPLISH WHATEVER SALUTARY OBJECTIVE IT IS INTENDED TO ACCOMPLISH.

SECOND, THE SECTION 338 ALL-OR-NOTHING RULE IS DESIGNED, OR AT LEAST HOPED, TO BE A SECOND BEST ANSWER TO A VERY IMPORTANT TAX PROBLEM, A PROBLEM FOR WHICH THE CORRECT SOLUTION IS BOTH CLEAR AND CURRENTLY ASSUMED TO BE UNPALATABLE. THE PROBLEM IS THE HISTORIC GENERAL UTILITIES DOCTRINE, THE NOTION THAT, ORDINARILY, A CORPORATION DOES NOT RECOGNIZE GAIN WHEN IT DISTRIBUTES APPRECIATED PROPERTY TO ITS SHAREHOLDERS. ALTHOUGH CONGRESS HAS CUT BACK SIGNIFICANTLY ON THE SCOPE OF THE DOCTRINE DURING THE PAST QUARTER CENTURY BY ENACTING DEPRECIATION RECAPTURE AND SIMILAR RULES, AND WILL DO SO AGAIN THROUGH THE BILL'S REPEAL OF SEGMENTS OF SECTIONS 311(D)(2) AND 346, THE CORE OF THE NON-RECOGNITION DOCTRINE REMAINS EMBEDDED IN PRESENT SECTIONS 311(A), 336, AND, BY EXTENSION, 337.

IF CONGRESS WERE TO REPEAL THOSE PROVISIONS, AND WITH THEM THE ENTIRE GENERAL UTILITIES DOCTRINE, OR IF CONGRESS WERE TO REPEAL THE MORE EXTREME ASPECTS OF THE DOCTRINE BY SUBJECTING TO CORPORATE TAX THE APPRECIATION IN DISTRIBUTED ORDINARY INCOME ASSETS AND SECTION 1231(B) TRADE OR BUSINESS ASSETS, WE WOULD HAVE IN HAND THE RIGHT ANSWER TO THE PROBLEM. SECTION 337, THE OPERATIVE PROVISION THAT IS VOUCHED IN UNDER PROPOSED SECTION 338, THEN WOULD REQUIRE THAT H CORPORATION, AS THE PRICE OF STEPPING UP THE BASIS OF ITS HOTEL, MUST PAY TAX ON THE ENTIRE APPRECIATION IN THE VALUE

OF THAT PROPERTY AND NOT MERELY ON ITS MINOR AMOUNT OF RECAPTURABLE DEPRECIATION. AND THIS WOULD BE SO WHETHER P PURCHASED H AND W CORPORATIONS FROM A CORPORATE SELLER OR FROM AN INDIVIDUAL SELLER, OR PURCHASED ONLY H AND NEVER ACQUIRED W CORPORATION AT ALL.

IF CONGRESS WERE MINDED TO DEAL DIRECTLY WITH THE GENERAL UTILITIES PROBLEM IN THIS FASHION, TO PROFFER THE ONLY EFFECTIVE ANSWER TO THAT PROBLEM, PROPOSED SECTION 338 WOULD NOT CONTAIN AN ALL-OR-NOTHING RULE BECAUSE THERE WOULD BE NO REASON TO SUPPLY AN INADEQUATE ANSWER IN ADDITION TO A RIGHT ANSWER. THE TREASURY DEPARTMENT, AMONG OTHERS, RATHER CANDIDLY TESTIFIED TO THIS EFFECT AT THE MAY 24, 1982, HOUSE HEARING ON H.R. 6295, THE BILL THAT FIRST PROPOSED ENACTMENT OF SECTION 338.

IN SUM, THEN, THE ALL-OR-NOTHING PROVISION OF PROPOSED SECTION 338 IS OFFERED IN THE HOPE IT WILL BACKSTOP THE BILL'S MORE SPECIFIC AMENDMENTS, AND IN THE HOPE IT WILL SERVE AS SURROGATE FOR A TRULY EFFECTIVE, AND MUCH NEEDED, SOLUTION TO THE GENERAL UTILITIES PROBLEM. NEITHER HOPE, IN MY VIEW, IS AN ADEQUATE REASON TO ENACT THE PROPOSED ALL-OR-NOTHING RULE.

B. UNDERLYING POLICY

OUR CORPORATE TAX SYSTEM HAS A LONGSTANDING COMMITMENT TO ACQUISITION ELECTIVITY. THE CHOICE -- PRESERVATION OF HISTORIC ASSET BASIS THROUGH A SIMPLE PURCHASE OF THE STOCK OF TARGET, ON THE ONE HAND, OR A TARGET ASSET PURCHASE OR TARGET STOCK PURCHASE FOLLOWED BY LIQUIDATION PRODUCING A PURCHASE PRICE ASSET BASIS AT A "RECAPTURE" TOLL CHARGE DESIGNATED BY CONGRESS AND KEYED TO

APPRECIATION IN THE ASSETS STEPPED-UP -- IS A CENTRAL PART OF THE TAXING POLICIES UNDERLYING SUBCHAPTER C.

SELECTIVE ELECTIVITY HAS BECOME A SERIOUS PROBLEM UNDER PRESENT LAW, NOT BECAUSE THE BASIS OF THE ASSETS OF ONE CORPORATION HAS BEEN STEPPED-UP AND THE BASIS OF THE ASSETS OF A DIFFERENT CORPORATION HAS NOT BEEN STEPPED-UP, BUT RATHER BECAUSE SOPHISTICATED CORPORATE BUYERS HAVE BEEN ABLE TO USE THE PROVISIONS OF PRESENT LAW TO DEFER OR WHOLLY AVOID PAYING THE TOLL CHARGE TAX ON THE ASSETS THAT ARE STEPPED-UP. THIS ABUSE IS THE COMMON DENOMINATOR OF THE RECENT, PUBLICIZED TRANSACTIONS THAT INCITED THE LEGISLATION NOW BEFORE THE COMMITTEE. IN EACH CASE PRESENT LAW WAS OPERATING IN A MANNER INCONSISTENT WITH UNDERLYING TAX POLICY.

THE BILL'S SPECIFIC AMENDMENTS, IN PARTICULAR SECTIONS 311(D)(2), 346, AND 302(E), DEAL DIRECTLY AND EFFECTIVELY WITH PRESENT LAW'S POTENTIAL FOR ABUSE. WHEN THESE SALUTARY PROVISIONS ARE ENACTED, TAXPAYERS NO LONGER WILL BE ABLE TO STEP-UP THE BASIS OF SELECTED ASSETS OF A CORPORATION AND AVOID CURRENT PAYMENT OF THE CONGRESSIONALLY DESIGNATED TAX APPROPRIATE TO THAT BASIS INCREASE.

THE BASIC NOTION OF REPLACING SECTION 334(B)(2) WITH ELECTIVE SECTION 338 COMPORTS WITH AND FURTHERS THE SOUND OBJECTIVE OF THESE TAILORED AMENDMENTS, AND PROVIDES AS WELL AN EXTREMELY IMPORTANT PLATFORM FROM WHICH TO HARMONIZE AND SIMPLIFY THE NOW INORDINATELY COMPLEX AND DISPARATE TAX RULES THAT GOVERN CORPORATE ACQUISITIONS.

BUT THE SEGMENT OF PROPOSED SECTION 338 THAT GENERALLY CONDEMNS SELECTIVE ELECTIVITY IS A HORSE OF A DIFFERENT COLOR. IT DOES NOT RESPOND TO THE SPECIAL ABUSES OF PRESENT LAW. INSTEAD, THE PROPOSED ALL-OR-NOTHING RULE, WERE IT TO BE EFFECTIVE IN PRACTICE, WOULD UNBALANCE THE SYSTEM IN A DIFFERENT WAY. TAX THAT RELATES TO THE SELECTED ASSETS WOULD BE PAYABLE, BUT TAX HAVING NO RELATION TO THE SELECTED ASSETS INAPPROPRIATELY WOULD BE CHARGED AS WELL.

IN APRIL OF THIS YEAR, AFTER EIGHT YEARS OF EXTENSIVE WORK, THE FEDERAL INCOME TAX PROJECT OF THE AMERICAN LAW INSTITUTE PUBLISHED ITS STUDY OF AND PROPOSALS TO REVISE SUBCHAPTER C, THE PROVISIONS THAT GOVERN THE TAXATION OF CORPORATIONS AND THEIR SHAREHOLDERS. THE PROJECT'S REPORT WAS FORMULATED BY A REPORTER, PROFESSOR WILLIAM D. ANDREWS OF HARVARD LAW SCHOOL, A DOZEN OR SO CONSULTANTS, AN ADVISORY GROUP OF SOME 100 TAX LAWYERS FROM GOVERNMENT, PRIVATE PRACTICE, AND THE ACADEMIC WORLD, AND A LIAISON COMMITTEE OF THE TAX SECTION OF THE AMERICAN BAR ASSOCIATION. IN DEVELOPING AN OVERALL APPROACH TO RATIONALIZING THE TAXATION OF ALL FORMS OF CORPORATE ACQUISITION, STOCK OR ASSETS, TAXABLE OR NON-TAXABLE, THE FEDERAL INCOME TAX PROJECT CONCLUDED THAT SELECTIVITY -- THE ABILITY TO STEP-UP THE BASIS OF THE ASSETS OF H CORPORATION AND PRESERVE THE HISTORIC BASIS OF THE ASSETS OF W CORPORATION -- IS A POSITIVE FEATURE OF OUR TAXING SYSTEM WHICH, CLEANSED OF PRESENT LAW POTENTIALS FOR ABUSE, SHOULD BE PRESERVED AND, INDEED, ENHANCED.

OVER THE PAST MORE THAN 30 YEARS THE TAX WRITING COMMITTEES OF CONGRESS HAVE FOUND THE TAX WORK OF THE AMERICAN LAW INSTITUTE BALANCED AND THOUGHTFUL, AND HAVE PAID MUCH DESERVED ATTENTION TO ITS REPORTS. OVER THE YEARS THE WORK OF THE FEDERAL INCOME TAX PROJECT HAS IMPACTED SUBSTANTIALLY AND BENEFICIALLY ON THE TAX LEGISLATIVE PROCESS.

THE PROPOSAL CURRENTLY BEFORE THE COMMITTEE, ADVANCING A WHOLESALE CONDEMNATION OF SELECTIVE ELECTIVITY, IS NOT THE PRODUCT OF EXTENDED STUDY OR A CAREFUL IDENTIFICATION AND WEIGHING OF IMPACTS ON THE TAXING SYSTEM AS A WHOLE. WHOLLY INCONSISTENT WITH THE AMERICAN LAW INSTITUTE'S APPROACH, THE ALL-OR-NOTHING PROPOSAL, IF ENACTED, WILL STAND AS A ROADBLOCK TO THE CREATION OF SENSIBLE, COHERENT CORPORATE TAX RULES.

C. THE RULE IN PRACTICE

THERE IS AN ADDITIONAL REASON TO REJECT THE PROPOSED ALL-OR-NOTHING RULE.

QUITE SIMPLY, IT WILL NOT WORK IN PRACTICE. THE SOPHISTICATED CORPORATE TAX BAR, AN INGENIOUS LOT, FOR MUCH FUN AND AT GREAT PROFIT WILL TRASH THE STATUTORY SCHEME. IT IS NOT, I THINK, A QUESTION OF "HOW" BUT RATHER OF "HOW MANY," HOW MANY DIFFERENT WAYS TAX PRACTITIONERS WILL FIND TO DO THE NEW LAW IN.

RETURN TO H CORPORATION AND ITS HOTEL, W CORPORATION AND ITS WIDGET BUSINESS, AND ASSUME BOTH ARE WHOLLY-OWNED SUBSIDIARIES OF T, A HOLDING CORPORATION OWNED IN TURN BY MR. A. MR. B OR A WHOLE GROUP OF BS OWNS P CORPORATION AND P OR A P SUBSIDIARY OR BOTH WISH

TO ACQUIRE AND ELECT SELECTIVELY. T IS PREPARED TO SELL ITS SUBSIDIARIES, OR CAUSE THEM TO CONVEY THEIR ASSETS, AND WHEREVER APPROPRIATE T WILL AVOID CORPORATE LEVEL TAX THROUGH A LIQUIDATION THAT COMPORTS WITH SECTION 337.

THE FOLLOWING ARE SOME OF THE POSSIBILITIES THAT OCCUR UPON FIRST READING. AS EVER, EXPERIENCE WILL SUPPLY MANY MORE.

1. A LEASING ARRANGEMENT

P PURCHASES THE STOCK OF W CORPORATION. NO SECTION 338 ELECTION IS MADE. P'S INVESTMENT BANKERS ARRANGE FOR THE FORMATION AND FUNDING OF NEW D CORPORATION ONE OF THE SHAREHOLDERS OF WHICH MAY, OR MAY NOT, BE P (OWNING LESS THAN 80% OF D). D PURCHASES EITHER THE ASSETS OR THE STOCK OF H CORPORATION; IF THE STOCK IS PURCHASED A SECTION 338 ELECTION IS MADE. THE HOTEL PROPERTY THEN IS LEASED LONG-TERM TO P'S WHOLLY-OWNED SUBSIDIARY, S CORPORATION, WHICH THEREAFTER OPERATES THE HOTEL BUSINESS.

2. A REORGANIZATION PLAN

P PURCHASES THE STOCK OF H CORPORATION. A SECTION 338 ELECTION IS MADE. W MERGES WITH AND INTO P'S WHOLLY-OWNED SUBSIDIARY, S CORPORATION, AND IN THE HANDS OF S THE HISTORIC BASIS OF THE ASSETS CARRIES OVER. IN THE MERGER T RECEIVES, IN EXCHANGE FOR THE SHARES OF W, SHARES OF P STOCK (COMMON OR PREFERRED) AND PERHAPS CASH AS WELL. SUBSEQUENTLY, T ELECTS TO SELL THE P SHARES, A TRANSACTION THAT MAY PRESENT SOME DIFFICULTY IF P IS CLOSELY HELD BUT NONE -- P'S INVESTMENT BANKERS ARE HARD AT WORK -- IF P IS A LARGE PUBLIC CORPORATION. UNDER SECTION 337, T RECOGNIZES NO GAIN.

3. THRESHOLD RECAPITALIZATION OF H OR W

T CAUSES W TO RECAPITALIZE: W CREATES AND DISTRIBUTES TO T SHARES OF A NEW CLASS OF NONVOTING PREFERRED STOCK OF W THAT CARRIES A PARTICIPATING (AS DISTINGUISHED FROM A LIMITED) RIGHT TO RECEIVE DIVIDENDS. ASSUME THE PREFERRED SHARES ARE WORTH $10,000. P PURCHASES ALL OF THE STOCK OF H AND A SECTION 338 ELECTION IS MADE. P PURCHASES ALL OF THE VOTING COMMON STOCK OF W AND T EITHER DISTRIBUTES OR SELLS TO ANYONE -- PERHAPS TO MR. B -- THE W PREFERRED SHARES AT FAIR VALUE. NO SECTION 338 ELECTION IS MADE WITH REGARD TO W CORPORATION AND, INDEED, UNDER THE PROPOSED STATUTE, IT WOULD APPEAR, NONE CAN BE MADE SINCE P HAS NOT PURCHASED "CONTROL" OF W WITHIN THE MEANING OF THE STATUTE. AT SOME MUCH LATER DATE, ONE HAZARDS, W WILL REDEEM OR P WILL ACQUIRE W'S OUTSTANDING PREFERRED STOCK.

4. DECONTROL ON P'S SIDE

S CORPORATION HAS ISSUED ALL OF ITS VOTING COMMON STOCK TO P IN EXCHANGE FOR CASH, AND ALL OF THE SHARES OF A NONVOTING CLASS OF STOCK -- PERHAPS NONVOTING COMMON STOCK OR NONVOTING PARTICIPATING (AS OPPOSED TO LIMITED) PREFERRED STOCK -- TO SOMEONE ELSE. PERHAPS TO MR. B IF P IS CLOSELY HELD AND PERHAPS TO A CHARITY OR EVEN A PENSION TRUST IF P IS WIDELY HELD. BECAUSE SHARES OF THIS SECOND CLASS ARE OUTSTANDING, S IS NOT A MEMBER OF P'S AFFILIATED GROUP OF CORPORATIONS. P PURCHASES THE STOCK OF H AND A SECTION 338 ELECTION IS MADE. S PURCHASES THE STOCK OF W AND NO SECTION 338 ELECTION IS MADE. P AND H LIKELY WILL FILE A CONSOLIDATED

RETURN; S AND W MAY FILE A CONSOLIDATED RETURN OF THEIR OWN. P AND S LIKE THIS PLAN SO MUCH THAT THEY USE IT EVERY TIME SIMILAR ACQUISITION OPPORTUNITIES ARISE. ON SOME DIM FUTURE DATE, PERHAPS, S WILL RETIRE OR CAST A VOTING RIGHT UPON ITS OUTSTANDING SECOND CLASS OF SHARES AND THEREAFTER ALL OF THE CORPORATIONS WILL BE IN ONE CONSOLIDATED GROUP.

5. SUBCHAPTER S AS A CONSOLIDATED RETURN SURROGATE

P PURCHASES THE STOCK OF H. A SECTION 338 ELECTION IS FILED. H LIQUIDATES INTO P UNDER SECTIONS 332(A) AND 334(B)(1). P MAKES A SUBCHAPTER S ELECTION. MR. B PURCHASES THE STOCK OF W (NO SECTION 338 ELECTION MADE OR, UNDER THE BILL, ALLOWED). W ALSO FILES A SUBCHAPTER S ELECTION. THE INCOME AND LOSSES OF P AND W CORPORATIONS NOW FLOW TO MR. B, RATHER AS IF HE WERE THE COMMON PARENT OF A CONSOLIDATED RETURN GROUP OF CORPORATIONS MADE UP OF HIMSELF, P (OPERATING THE HOTEL BUSINESS), AND W.

IT IS, UNFORTUNATELY, ALL TOO EASY TO CONJURE UP ADDITIONAL EXAMPLES. BUT SURELY THE POINT IS MADE.

THIS IS NOT A WORKABLE STATUTORY SCHEME. IT IS, RATHER, THE MOST UNFORTUNATE SORT OF TECHNICAL TAX LEGISLATION. IT IS AN INVITATION TO BYZANTINE TAX PLANNING FOR THE WEALTHY AND WELL-ADVISED, A TRAP FOR THE UNWARY AND UNSOPHISTICATED.

THE NOTION OF A SECTION 338 EXPLICIT ELECTION, IN LIEU OF PRESENT LAW'S SECTION 334(B)(2) ELECTION-BY-LIQUIDATION, IS WHOLLY SENSIBLE. IT WILL AVOID THE CURRENT NEED TO MAKE COSTLY, OFTEN IMPRACTICAL, AT TIMES IMPOSSIBLE TRANSFERS OF ASSETS. IT CLOSES PRESENT LAW'S SIGNIFICANT ABUSE POTENTIAL WHEN P CORPORATION POSSESSES A SIZABLE NET OPERATING LOSS. BUT THE SECOND HALF OF PROPOSED SECTION 338, THE ALL-OR-NOTHING RULE, IS UNSOUND IN CONCEPT AND UNWORKABLE IN PRACTICE. IT REDUCES ITSELF TO A WHOLLY IRRATIONAL NOTION: WHEN TWO OR MORE CORPORATIONS ARE PURCHASED FROM AN AFFILIATED CORPORATE GROUP, THE BUYING GROUP MAY FREELY

CHOOSE EITHER SELECTIVE ELECTIVITY OR A SINGLE CONSOLIDATED RETURN, BUT MAYBE NOT BOTH.

THE BASIC SECTION 338 ELECTION PROVISION SHOULD BE ENACTED. ITS ANTI-SELECTIVITY RULE SHOULD BE EXPUNGED AND, NOW OR SOON, FOCUS PLACED INSTEAD ON DIRECTLY CURTAILING THE REMAINING REACH OF THE PERNICIOUS GENERAL UTILITIES DOCTRINE.

STATEMENT OF HERBERT L. CAMP, ESQ., DONOVAN, LEISURE, NEWTON & IRVINE, ON BEHALF OF THE TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION, NEW YORK, N.Y.

Mr. CAMP. Mr. Chairman, my name is Herbert Camp. I am cochairman of the Committee on Corporations of the New York State Bar Association Tax Section. I request that my written statement be inserted in the record.

The tax section believes that the bill contains several good provisions, but, as some of the other witnesses have said, certain significant parts of the bill should not be enacted without further study.

We favor, although with certain changes, parts of the bill aimed at perceived takeover abuses, but the balance of the bill we think contains very complicated provisions which if enacted will produce an unworkable set of rules which Congress will no doubt find necessary to delay repeatedly, as has already happened in the case of net operating loss carryovers.

We believe that Congress should note the example of the Installment Sales Revision Act of 1980, a significant improvement in the tax law. That took over 1 year to enact and was a single purpose bill.

The present bill is in distinct contrast to that. It is to be taken up as part of a broad revenue-raising proposal under intense time pressure and without the deliberate study and reflection of the professional community.

Specifically, we are in favor of the elimination of section 334(b)(2) and its replacement with a new election under section 338. We have made several minor comments concerning the election period and concerning the calculation of tax basis. We hope they are taken into account.

But we are much opposed to the concept that new section 338 apply to all subsidiaries of a target corporation. The result is a very complicated statute bound to create problems of regulation, administration, and interpretation, not to mention difficulty for taxpayers, which are entitled to be able to plan transactions rationally.

Beyond all that complication, we see no good policy reason for the inclusion of subsidiaries. We understand that they are included to avoid giving a purchaser a selective tax basis stepup. We do not believe that selectivity is an abuse in that situation. The tax law has for many years allowed that choice.

The practical effect of the inclusion of subsidiaries is to go well beyond eliminating tax provisions favoring takeovers and maybe to stop altogether many acquisitions which would be healthy for U.S. commerce.

In the first place, the provision as to subsidiaries seems premised on an exaggerated view of a target corporation's ability under present law to tailor its assets in connection with a takeover. There are already ways to deal with that.

Second, if the target corporation has historically conducted business in subsidiaries, there seems to be no good reason to treat the purchase of stock of a subsidiary as an asset purchase just because the parent is purchased. That ignores the separateness of the corporate entities which would up to then have been, and will be after then respected.

Third, the proposed treatment of foreign subsidiaries is particularly onerous. U.S. taxation of preacquisition earnings will result for all foreign subsidiaries under the bill. There is no reason to accelerate the taxation of the earnings of foreign subsidiaries in a takeover. Those profits would still be taxed eventually when realized.

We strongly recommend that the extension to subsidiaries be deleted from the bill.

Next, I would like to talk about the two principal parts of title I of the bill, redemptions and partial liquidations.

As to redemptions, we do not believe that the Congress should now eliminate sections 311(d)(2) (A) and (B). Instead, we believe that those sections, particularly (B), should be amended to assure that they apply only to redemption distributions to historic shareholders and not in takeover situations.

Accordingly, we recommend that a redemption distribution come under (B) only if made to a 2-year or more shareholder. That change will effectively prevent a corporation from acquiring stock of another corporation to exchange for a subsidiary. Neither party would be willing to wait as long as 2 years.

With respect to partial liquidations, the tax section favors amendment of the consolidated return regulations or a legislative override to assure that there will be investment credit recaptures and current, not deferred, depreciation recaptures in an intercompany partial liquidation takeover context. Beyond that, we see no good reason for a total repeal of the partial liquidation provisions of the code. While a case could be made for repeal in the case of intercompany partial liquidations, we can see no reason, and certainly none related to corporate takeovers, to repeal partial liquidation treatment on distributions to noncorporate shareholders or less than 80 percent corporate shareholders. That is legislative overkill.

Last, I would like to urge that the effective dates in the bill be set so as not to unfairly penalize transactions in progress. We recommend December 31, not August 31.

Most, although not all, of the takeover techniques which the bill aims at are clearly mandated by current law and can even be the subject of favorable IRS rulings. People who have spent money preparing transactions based on current law should not be penalized by a quick, effective date.

Thank you.

Senator Danforth. Senator Byrd.

Senator **Byrd**. Thank you, Mr. Chairman.

When this matter came under discussion several weeks ago as a part of the 25-point tax package I think it was discussed not more than 20 to 30 minutes. I will admit what someone in my position should not admit: I could not understand the proposal. It seemed to me to be a very complex one and one that could have wide ramifications. Since no hearings have been held on it, while I was not against it I preferred to vote against it rather than to accept a proposal that I could not or did not fully understand the ramifications of.

I think you gentleman have, along with the Treasury, brought out that this is a complex piece of legislation. The ramifications are great. I think it is important that persons like yourselves should have the opportunity to present to this committee your thinking and your knowledge and your experience as to the value of such legislation.

It is now part of the tax package. I assume it will be enacted. I do not know whether it would be practical to attempt to amend it on the floor to correct some of the problems that each of you see. Maybe the effective date or something like that could be amended. But as a practical matter it appears to me that it is probably locked in. That being the case, you might want to consider getting up one or two amendments which clarify the more important aspects or difficulties you foresee with the legislation; and second, then to begin to try to get it corrected at the next session of the Congress.

In listening to the testimony I am inclined to think—I am inclined to agree with the four of you rather than to agree with Treasury. But also in listening to the four of you I am not sure just how serious a problem it would create for business if the legislation in the tax bill is enacted. I assume it will create some problems, but I do not know, judging from what all of you have said, just how great those problems really are.

Could one of you respond to that?

Mr. **Ginsburg**. Senator, I do not think we are all of the same mind, with one exception. I think that there are rather different views among us with respect to title I and with respect to the replacement of the section 334(b)(2) liquidation with a simple election. Probably on that latter our differences would end up relating to the amount of time one would have to make the election. I think 75 days will work out all right.

I suspect that Mr. Alexander would be of a different view. But we are, I think, all of one view on one thing, and that is that the all-or-nothing approach in section 338, the provision that says if you step up the assets of *H* you must step up the assets of *W*, does not make any sense at all. I believe that all of us have testified to that.

Mr. **Alexander**. I think all of us will surely agree as to that. Also, I think three of us will agree that the enactment of this legislation would produce serious problems and that would be a far better course if it is at all feasible—and I hope it is; otherwise, why are we having this hearing—if it is at all feasible to have the appropriate floor amendment which would deal with the perceived abuses, the horror cases we have been discussing this morning, without the overkill, without the overreach that at least three of us at this table perceive.

Now, there had not been enough time to consider this legislation. Now, Mr. Glickman pointed out it has been almost 2 months between the beginning and the end. Well, I just want to say that I think 2 months is too short a gestation period for either people or tax legislation; and surely the consideration that you are giving now would have been far preferable to have given before you had that markup on this legislation.

Senator **Byrd**. I think it is fair to say—and Senator Danforth could correct me—I think it is fair to say that so far as the Finance Committee was concerned this was never considered except for 20 or 30 minutes several weeks ago. It had never been presented to the committee up to that point to my knowledge.

So 2 months, as you say, is a relatively short time even if there were 2 months, which the committee did not have.

Mr. **Alexander**. Of course, you did not have 2 months. The 2-month period, or almost 2 months, is from the beginning of the consideration of Representative Stark's bill to the time of its adoption in major part by the Finance Committee at that 20 or 30-minute consideration.

Mr. **Nolan**. I might add that the Treasury's position on May 24 before the Subcommittee of the House Ways and Means Committee was far less certain than it is today. They had considerable concerns at that time about the bill and expressed the need for intensive study. Many of us have been attempting to give this matter further study in the interim period and are now convinced that there are serious problems in the broad aspects of this bill.

I do not think any of us disagree with the fact that there are problems that need to be solved, and we are suggesting specific solutions to those problems. But the broader ramifications of this bill are harder to evaluate. We think there will be adverse effects on small business. We do not think that is necessary.

We all prepared to engage in an intensive study in this area in the future just as we have with the installment sale bill, subchapter S bill, and others. But we just have not had time to think through all of the dangers that these broad changes could effect.

Senator **Byrd**. Well, I know the effective work that the Tax section of the American Bar Association has done on many pieces of legislation, and the Tax Section of the New York bar also, and many others, the chamber of commerce, Professor Ginsburg. And I do think that when we get into the very complex field of taxation that it is very important that this committee, as well as the entire Congress, have the benefit of the expert testimony such as you gentlemen are providing.

I do not suppose I have any additional questions, Mr. Chairman.

Senator **Danforth**. Let me ask you gentlemen to give me some for instances. It is clear that what we want to get at is the United States Steel/Marathon Oil, and the Mobil/Esmark type of a situation. And your testimony is that you believe that other types of transactions are caught in the net with this bill. And Mr. Alexander, I think, was the only witness who set forth his concerns with a kind of an example which was the splitup situation. And as I understand it, Treasury takes a position that it is possible, even if this were to become law, for splitoffs or spinoffs of small corporations to take place.

But I would like you, too, if you could, just to run through the examples which you believe would be caught in this net which you do not believe should be caught.

Mr. **Alexander**. A very simple case, then I yield to Mr. Nolan and Mr. Camp for other cases.

A very simple case would be a case that did not quite meet the standards that Mr. Glickman mentioned, which are those in current section 355, the spinoff provision of the Internal Revenue Code. One of the requirements for a spinoff is that you have a separate business conducted for 5 years. If you meet the requirements for a section 355 spinoff, you not only have no tax at the level of the distributing corporation, but you have no tax at the level of the recipient shareholder.

We are not talking about the latter case. We are talking about whether there should be a double tax, whether the corporation should realize and recognize taxable gain when it makes the distribution to one of its owners, or that the business had been conducted for 4 years rather than 5.

Senator **Danforth**. Maybe that would argue for changing the spinoff rule.

Mr. **Alexander**. I believe, as Mr. Nolan suggested, it would be an excellent idea for the Congress to readdress subsection (c)

Senator **Danforth**. This is not a new policy, is it, Mr. Alexander? This was established with the old rule.

Mr. **Alexander**. The spinoff provision has been with us for many years. It was developed out of a much narrower provision. What was it, 112(b)(7), Professor? My guidance over here.

Senator **Danforth**. What you really want is a less than 5-year rule.

Mr. **Alexander**. That is one example.

Senator **Danforth**. Other than reducing the number of years, what else?

Mr. **Alexander**. What if we caught in this a segment of a business? What if we do not have a business at all, but we have in order to preserve a business by reason of the very needs of its owners or a variation, and it is ours, one of the owners must have certain assets which independently do not constitute a business, or it is going to insist that the business be sold.

Senator **Danforth**. Are you talking again about the spinoff or splitoff?

Mr. **Alexander**. I am on a slightly different track. I am talking about a genuine contraction in the business that can qualify under present 346, the partial liquidation provision, but would have great difficulty qualifying by reason of stock ownership and attributed stock ownership as a capital gain to the recipient shareholder. And we are discussing whether there should be among other things an elimination of current section 346 of the recognition of tax at the corporate level in such a case; and these frequently arise in connection with small businesses.

Should the general utilities rule, the rule that prohibits tax at the corporate level and the corporation is making its distribution to an owner rather than a sale to an outsider, be repealed under these circumstances. We do not think it should.

Senator Danforth. OK. What else? What are some other specifics?

Mr. Alexander. Well, at this point I know Mr. Nolan has four or five examples, and I think I have taken up enough time of the committee already.

Senator Danforth. The problem, I think, with anything of this nature, is that the comments about it are going to be broad principles of taxation, and what I wanted to find out are what sort of specific transactions any of you believe will be covered by the bill that should not be covered by the bill.

Mr. Alexander. I have given you a couple, and I am glad you are inquiring into that, because you remember the suggestion was made by Treasury that we needed to have a very broad solution to very specific problems, because somebody else might be looking at that, but they did not define what that look at might be.

Mr. Nolan. I have identified some specific examples in my written statement of problems, some of which have been discussed here. The corporate contraction problem involves a change. The bill would change the tax treatment at the shareholder level as well in that case. Thus, if you have, for example, part of an existing business of a company destroyed by fire or by some other act of God or of that nature, and the proceeds are distributed, traditionally that distribution has resulted in a capital gain consequence to the shareholders.

This bill would change that result. That transaction has nothing to do with corporate acquisitions. There is a fundamental question whether we should impose an ordinary income tax on an extraordinary event like that where a corporation distributes a substantial amount of assets to its shareholders. There is a genuine contraction of the business. Should we change that from a capital gains transaction, as it has traditionally been, to an ordinary income transaction? That is an issue that perhaps people could come out on either way, but it needs a lot of debate, and it has nothing to do with corporate acquisitions, and ought not to be changed by this bill.

Mr. Camp. Another example of a transaction that is picked up by the bill that has nothing to do with a corporate takeover is a distribution of a subsidiary of a corporation to an historic shareholder in redemption of stock. That could often happen. It obviously has nothing to do with a takeover.

But the repeal of section 311(d)(2)(B) would catch that transaction. It is not necessary to do that. It may be right to do it. That is a very broad question of tax policy that deserves debate. That is the general utilities problem, and to address that you have to address the question of the integration of the corporate and individual tax system. If you want to do that in the context of a bill like this, all right; but there really has not been adequate study to do that.

Senator Danforth. Anything else, Mr. Ginsburg?

Mr. Ginsburg. Would you take a slightly dissenting view, Mr. Chairman?

The sort of situation that I think has been referred to here is, I believe, rather the tail on this large dog. And in any event is, I think, very difficult to conjure up a lot of sympathy for.

Mr. Alexander mentioned you must have a business that you can divide into separate businesses. In fact, the way section 355, the splitoff provision, has developed in the courts, you do not need two separate businesses in order to make a division when one shareholder wants to stay in and the other one hates the first shareholder and wants to separate out in a tax-free manner.

With respect to the problem of the fire and the distribution of the proceeds, that is a pointed example because it is one of the most famous cases in this field, one that teachers give to students. It is a case called *Imler* in which the top three floors of the building burned down, and instead of taking the fire insurance proceeds, fixing the building and continuing along as they would have otherwise, some clever tax lawyer pointed out that they could distribute the cash as a dividend to the shareholders but it would be taxed as capital gain.

I do not think that current law permission should be the sort of thing that encourages you to abandon title I of this bill. It is undoubtedly true that everything in subchapter C interacts with everything else, and it is undoubtedly true that it is long overdue for us to reconsider the whole thing; but if we wait until we are finished, it will be about the year 2012.

Senator BYRD. I want to ask a question in clarification.

Mr. Alexander, you brought up the spinoff. I understood from Treasury's reply to my query that this does not affect the spinoff.

Mr. ALEXANDER. I think they contended it does not affect the current spinoff provision, section 355. I think it was suggested that spinoff is an adequate substitute for use in situations where enactment of this bill would deny use of the previous techniques warranted by the statute that were employed to do two things: No. 1, to make a distribution to a stockholder of small business, of a segment, maybe not a business in itself since it might not quite meet the *Cordy* and *Merett* cases that Professor Ginsburg alluded to. But a segment of a business that has been discontinued or proceeds of the involuntary disposition by fire or otherwise part of that business.

Section 355 will not work under those circumstances. You cannot have a spinoff, and you cannot have a spinoff anyway unless you meet the 5-year tests and some other tests. So some of us do not think that the suggestion that there is an adequate remedy elsewhere in the law for deleting the partial liquidation provisions of the law is well founded.

Mr. NOLAN. I would like to express my disagreement with Treasury on that point, because the bill would change the tax consequences of a form of spinoff, a very common form and a very important form. We call it a splitoff where you have an existing subsidiary of a parent company. Say, for example, you have two shareholders and they disagree as to management policy, and one would like to take the business that is in the subsidiary and one would like to take the business of the parent. Traditionally that has been a wholly nontaxable transaction, and in my view should continue to be a wholly nontaxable transaction. But this bill would change the treatment; it would impose a tax at the corporate level with respect to the distribution of the stock of the subsidiary to the one shareholder.

Senator BYRD. I thought Treasury testified differently. Let me state the case as I understand it, and then you can correct me.

Corporation A owns 100 percent of corporation B, and corporation A has held that for 5 years, and corporation A spins off the shares of corporation B to the stockholders of corporation A. Well, now, there is no taxable problem there, is there?

Mr. NOLAN. If it is a pro rata distribution to the existing shareholders, there is no problem. The bill does not change it. On the other hand, if it is not pro rata but rather is a distribution of all the stock in a subsidiary to some of the shareholders or to one of the shareholders of the company, then this bill will change the result.

Senator BYRD. I see.

Mr. NOLAN. And that is precisely the case, in my judgment, where it ought not to change the result.

Senator BYRD. Well, now, let us assume that under the present law it is distributed pro rata to the shareholder, and then the shareholders subsequently sell the spinoff stock or subsequently dissolve the corporation. Is there a taxable problem at the moment?

Mr. NOLAN. Yes. If they subsequently dissolve the corporation, there is going to be a tax at the shareholder level in those circumstances.

Senator BYRD. But your point is that this bill, this legislation does change the present law on spinoffs unless it is spun off in proportion to the stock held by the individuals.

Mr. NOLAN. That is my view if the stock spun off is an existing subsidiary as opposed to creating a new subsidiary. If you could create a new subsidiary, you could use the reorganization provisions to avoid tax at the corporate level, but if the subsidiary is an already existing subsidiary, as will often be the case, I do not think you can do that. I think there will be a change in existing law.

Senator DANFORTH. Mr. Ginsburg, do you have a comment?

Mr. GINSBURG. I almost never disagree with Mr. Nolan based upon some frightful earlier experiences in my life, but this once I would like to hazard—

I do not think that is what the bill really does. There is a similar linguistic problem under present law in the interaction of current section 311(d) and section 355. To the best of my knowledge the answer is, and would remain under the bill, that the non-pro rata or pro rata splitoff or spinoff of an existing subsidiary, qualifying under section 355, would never fall into part I of subchapter C, the 311 rules, which is a complicated way of saying it is OK.

Senator DANFORTH. Well, let me just say we will be happy to look at the drafting and the possibility of any technical changes in this bill. It has a long way to go certainly in the House and conference. But clearly, the objective of this bill is not to get at what are now spinoffs or splitups of family owned corporations. That is ridiculous.

What this is aimed at getting at is what has become a national rage—corporate acquisitions and mergers—and the effect of the Internal Revenue Code in encouraging artificially, corporate acquisitions and mergers. And we will be happy to work with the staff of the joint committee and the Treasury on this matter; and I will be happy to review and we will review very carefully any and all of the examples which you care to put forward on what you think is caught by this bill that is not intended to be caught. This is not designed to be a trap for mom and pop or for the Smith Brothers who want to break up the cough drop business or whomever or any worthy endeavor. This is an effort to try to remove what we believe is an anomalous situation in the Internal Revenue Code where there are tax advantages to be gained by corporate acquisitions, mergers, the Esmark case and so on and so forth. So we will be happy to look at your problems, but I would also say this to you.

I do not agree that this is some great surprise that nobody has ever thought about. I think that you gentlemen have illustrated by your testimony that this is a matter on which there is profound expertise of the bar and great knowledge in the Treasury and in the joint committee upon which hearings have been held in the Ways and Means Committee and now, of course, in the Finance Committee. So I do not think that this is just a surprise.

It is difficult, as Mr. Ginsburg pointed out, to pick up the paper without seeing some case being discussed in the paper. This has become a fine art in the tax bar. So all of this business about oh, gee, we never thought of this one before is just I do not think plausible. But we will be happy to review any of your concerns and in fact will review any of your concerns. And in a few minutes I would like to ask Treasury to respond to those concerns which you express.

Mr. Nolan. Senator Danforth, perhaps you could ask Professor Ginsburg whether the narrow solutions that Mr. Camp, Mr. Alexander, and I have suggested respond to those cases that you are worried about.

Senator Danforth. Well, what do you think, Dr. Ginsburg?

Mr. Ginsburg. I do not think you can really effectively legislate the objective of title I in the real world unless you do it in a very clean way. If you adopt a statutory rule that says that historic shareholders are all right, they can receive the distribution in redemption of stock that does not trigger a gain at the corporate level, then you will have to define the historic shareholders.

Now, I assume that probably my colleagues on the panel, or at least two out of three, would say 1 year, 18 months, 2 years, and you are now a historic shareholder. The notion then would be that nobody would buy into the corporation or buy the corporation with the intention of sitting still for the period of time.

In my testimony at the outset I referred to the deviously patient, and this problem is exactly what I had in mind. The tax law is replete with cases on the books of people who have done exactly this sort of thing in order to get the kind of benefits that we have been looking at in the newspapers. There is a wonderful old case called *Milton Friester,* a very carefully engineered transaction in which shares went from *A* to an independent lumberman, and, when enough time had passed, pursuant to a nice, preconceived understanding the shares were redeemed.

Now, it will, I guess, become the tax lawyers' full employment act if you are going to go in that direction. I do not think it a very effective or desirable way to legislate in this area, and that is why I said at the outset this bill goes about a business in a clean way, and that is why it is going to work.

[The prepared statement of Mr. Camp follows:]

STATEMENT OF HERBERT L. CAMP

before the Senate Committee on Finance

on behalf of

THE NEW YORK STATE BAR ASSOCIATION TAX SECTION

Concerning S. 2687

(Corporate Takeover Tax Act of 1982)

July 15, 1982

My name is Herbert L. Camp. I am Co-Chairman of the Committee on Corporations of the Tax Section of the New York State Bar Association. The Tax Section has over 2,800 members, all of whom are lawyers with a professional interest in taxation. They include practicing lawyers, judges, professors of law, corporate counsel, and officials and employees of the Treasury Department and the Internal Revenue Service.

I am pleased to testify with respect to S. 2687 (the "Bill"), introduced by Senator Danforth, concerning certain tax aspects of corporate takeovers. The Bill is substantially indentical to H.R. 6725, introduced by Mr. Stark on June 28, 1982, and is similar to H.R. 6295, previously introduced by Mr. Stark.

I would like to comment particularly on Title II of the Bill, dealing with proposed new section 338 of the Internal Revenue Code (the "Code"), and Sections 101 and 102 of the Bill, dealing with, respectively, partial liquidations and redemptions using appreciated property.

I. General.

The Tax Section is in favor of parts of the Bill which seek to abolish certain provisions of the tax law which, perhaps contrary to Congress' intention, may unduly facilitate certain corporate acquisitions. The Tax Section is opposed, however, to enactment without further study of those parts of the Bill which go beyond the correction of those perceived abuses. The Bill in its present form contains many complicated provisions. There is a significant risk that the Bill, if enacted without change, will produce an unworkable set of rules which the Congress will find necessary to delay pending further study, as has happened repeatedly in the case of section 382 of the Code (involving loss carryovers).

Congress should, we believe, note the example of the Installment Sales Revision Act of 1980, which, most agree, was a significant improvement in the tax law. That Act took over one year to approve, and was a single-purpose bill. The present Bill is in distinct contrast to that situation in that it is to be taken up as part of a broad revenue raising proposal, under intense time pressure, and without the deliberate study and reflection of the professional community. The result will, we fear, not be improvement of the tax law, but only its complication.

II. Section 338.

A. Description of Section 338. Title II of the Bill would, essentially, repeal section 334(b)(2) of the Code and substitute for it new section 338. Under the new section, a corporation acquiring 80% or more of the stock of another corporation (the "Target Corporation") within a certain time period could elect to treat the Target Corporation as if it had sold all its assets in a section 337 transaction at a price based on the purchase price for the stock.

Significantly, the section 338 election as to a Target Corporation would also apply to all its direct and indirect subsidiaries ("Target Affiliates"), including foreign subsidiaries. Sections 338(e) and (g)(3)(B). Moreover, the section 338 election would be deemed made as to a Target Corporation (and therefore as to all Target Affiliates) if any asset of the Target Corporation or a Target Affiliate were acquired by the purchasing corporation during a period (called the "Consistency Period") beginning one year before the acquisition period and ending one year after it. Section 338(d)(1).*

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* An exception is provided, so that there would be no deemed election, in the case where the acquiring corporation's basis in the asset was determined by reference to the transferor's basis or the transfer was an ordinary - course-of-business sale. Section 338(d)(2).

As a result of that rule, a corporation acquiring assets in a section 337 transaction would be deemed to have elected under section 338 with respect to any acquired subsidiaries (because such subsidiaries would be Target Corporations and assets would have been acquired, within the Consistency Period, from an affiliate (the parent which sold in the section 337 transaction)). Likewise, if a corporation were liquidated under sections 331 and 336 of the Code, and its assets, or some of them, including subsidiaries, were sold by the shareholders to an acquiring corporation, section 338(e) would require that if section 338 were elected as to one acquired subsidiary, it would have to be made as to all acquired subsidiaries.

The election under section 338 is to be made within 75 days after the acquisition of the requisite 80% stock interest.

B. Comments.

1. General. The Tax Section is in favor of the repeal of section 334(b)(2) and the substitution of an election not requiring an actual corporate liquidation in order to treat the transaction as an asset acquisition. The effect under the Bill would be to shorten considerably, compared to present law under section 334(b)(2), the maximum period between the effective date of the stock acquisition and the deemed asset purchase. The Tax Section believes that

the resulting elimination of complicated interim earnings and profits calculations and other adjustments to tax basis is a desirable simplification of the tax law.

2. Election Period. We believe that 75 days is far too short a time period in which to determine the desirability of, and make, the section 338 election. Whether the election is desirable will depend in the usual case on a complex interplay of factors, including valuations, discounting of tax benefits, and determination of recaptures. Moreover, there would appear to be no detriment to the parties or the government if the election period were extended. We would suggest that the acquiring corporation be permitted to make its section 338 election as late as the actual filing date of the first tax return (its own or the seller's) for a period after the acquisition, since that is the first time it will make a difference whether the election is made. Alternatively, the election period could end 9 months (plus 15 days) after the acquisition, since, in many cases, neither return would be filed before then (taking into account extensions of time).

3. Basis. The Bill provides that the basis of assets under a section 338 election is the purchasing (electing) corporation's basis for the acquired stock, properly adjusted for liabilities and other relevant items. Where 100% of the Target Corporation's stock is acquired, the basis calculation should be relatively straightforward,

and that is a distinct improvement over present law. It is not entirely clear, however, what the basis is in the case of a less-than-100% purchase of stock. Presumably, the Target Corporation's existing asset basis continues to the extent of the percentage of stock not acquired. For instance, if only 80% of the Target Corporation is purchased, for $8 million, liabilities of the Target Corporation are $4 million, and the assets have an old tax basis of $6 million, then the assets should have a new basis of $12.4 million ($8 million, plus 80% of $4 million, plus 20% of $6 million.)* Perhaps the basis rules in such a case could be spelled out in the statute or the legislative history.

Also, a case could be made to treat certain preferred stock, not acquired by the acquiring corporation, like a liability for purposes of basis calculations. For instance, if 100% of the common stock of a Target Corporation were acquired for $8 million, there were no liabilities, the assets had an old basis of $2 million and there were $2 million in liquidating value of preferred stock, which was not acquired, then treating the preferred stock as stock would produce a new asset basis of $8.4 million, but treating the preferred stock as a liability would result in a new asset basis of $10 million.

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* Another way to look at it is to observe that, in a 100% purchase (for $10 million), basis would be $14 million, or an $8 million step-up. 80% of $8 million is $6.4 million, which, when added to the existing $6 million of basis, equals $12.4 million.

4. Subsidiaries. We have great difficulty with the complex rules in proposed section 338 which mandate that the election apply to all subsidiaries (including, as mentioned above (pages 3-4), in section 337 and certain section 331 situations).

We understand that those complicated provisions are included in order to avoid giving a purchaser a "selective" step-up in basis. We do not believe that the buyer's choice as to which corporations should be subject to a step-up in basis, with attendant recaptures, is an abuse. The corporate tax law has for many years permitted a purchaser that choice, and a change at this point would dramatically affect the value of existing corporations that own subsidiaries. The practical effect of the solution in the Bill requiring complete step-up and recapture for all subsidiaries is to go well beyond the elimination of tax provisions which unduly favor corporate takeovers, and may be to stop altogether many acquisitions which otherwise would occur and the consummation of which would be healthy for U.S. commerce.

In the first place, the provisions as to subsidiaries seem to be premised on an exaggerated view of a corporation's ability under present law to tailor its assets in connection with a takeover transaction. The proposed treatment of subsidiaries is not necessary to deal with the situation where a target corporation, in anticipation of its sale, rearranges its affairs, for instance, by placing in a subsidiary assets which would not be desired, because of heavy recaptures, to be stepped up. Such a rearrangement could well be subject to a section 269 or other* attack. Even if not, however, it could be considered part of an overall plan so that section 338 would apply to the assets of the Target Corporation and those so placed in a subsidiary. That would make it unnecessary to have an automatic rule requiring that all subsidiaries be the subject of the election.

Second, if the Target Corporation has historically conducted business in subsidiaries, there seems to be no good reason to treat the purchase of stock of subsidiaries as an asset purchase merely because the parent corporation's assets are purchased, or treated as purchased. Such treatment in effect ignores the separateness of the various corporate entities which would theretofore have been respected. On the other hand, the separateness continues to be respected for other purposes. For instance, the liquidation of a parent corporation does not fail to be a complete liquidation merely because its subsidiaries are not also liquidated.

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* See, Telephone Answering Service Co. v. Commissioner, 63 TC 414 (1974), aff'd., 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977) (no complete liquidation where some assets remain in corporate solution after the transaction).

Third, the proposed treatment of subsidiaries is particularly onerous in the case of foreign subsidiaries that are controlled foreign corporations. A step-up in asset basis with respect to such subsidiaries is not likely to result in any decrease in U.S. taxation; but under section 338 the assets of each foreign subsidiary will be deemed to have been disposed of, and apparently each subsidiary will be deemed liquidated, in every section 338 situation. In that event the United States shareholder would be taxable on income equal to the "all earnings and profits amount" of the foreign subsidiaries or, at the election of the shareholder, all the gain on the liquidation would be taxable, and section 1248 would apply to the extent of post-1962 earnings and profits. See, Temp. Reg. § 7.367(b)-5.* Moreover, the deemed asset sales by the subsidiaries will produce recapture of depreciation with respect to personal property which will increase their earnings and profits which in turn are taxed under either section 367 or section 1248. Because of the increase in earnings and profits, a "dilution" of any foreign tax credit associated with the subsidiary's earnings and profits will also result.* There is no reason to accelerate the taxation of the earnings and profits of foreign subsidiaries in a takeover situation; foreign profits will still be subject to U.S. taxation when actually realized, by sale or distribution, in later years. Such mandatory acceleration of tax may well frustrate, or at least greatly complicate, normal acquisitions which are beneficial to the U.S. economy.

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* Another possibility would be to view the transaction as a sale of stock of the first tier foreign subsidiary subject to section 1248. Under section 1248, gain recognized on the sale of stock of a controlled foreign corporation by a United States shareholder is generally taxed as a dividend to the extent of the controlled foreign corporation's post-1962 earnings and profits. Section 1248 tax applies already in the case of first-tier foreign subsidiaries of a target corporation whose assets are sold or which is liquidated, even if gain is generally not recognized under sections 337 or 336. Section 1248(f) of the Code. Under the Bill, the election (or deemed election) under section 338 with respect to a domestic subsidiary could in effect result in section 1248(f) treatment of lower-tier foreign subsidiaries.

The extension of section 338 to subsidiaries will also cause taxation of accumulated DISC income of lower-tier DISC subsidiaries. As in the case of foreign subsidiaries, the sale of the stock or assets of the remote parent of the DISC seems to be an inappropriate reason to end the DISC deferral; the result will be to eliminate the favorable export incentive of the DISC structure.

Another consequence of the extension to subsidiaries could arise in the case of life insurance subsidiaries, which would be deemed to have sold their assets and could, as a result, incur substantial--and we believe unintended--tax liability, well beyond mere recaptures, as a result of the transaction.

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* On the other hand, no step-up is likely to be allowable for foreign tax purposes, with the results that future foreign taxes will be higher than using U.S. concepts of taxable income, and that excess foreign tax credits may result in later years. In the end, there could be substantial unwarranted double taxation, United States and foreign, on the foreign earnings.

Finally, the extension of section 338 to subsidiaries makes the section far more complicated and burdensome than it would be without such extension.

We strongly recommend that the provisions of the Bill which require that the section 338 election be applicable to subsidiaries be deleted. A separate section 338 election should be available for each subsidiary that was acquired by "purchase," provided that each higher-tier subsidiary in the chain of which the subsidiary was a part so elected. At most, section 338 could include a provision to the effect that the election would extend to assets transferred from the Target Corporation to its affiliates within two years of the acquisition, unless the taxpayer established that the transfer was not effected for the principal purpose of avoiding a section 338 election as to them. If, following enactment of the Bill in that form, it became apparent that a strengthening of section 338 were required, that could occur; but it is not desirable at present to take so radical a step as the Bill now contemplates.

III. Redemptions using Appreciated Property.

A. Description of Bill. Section 102 of the Bill would repeal sections 311(d)(2)(A),(B),(C) and (G) of the Code. Those sections provide four exceptions to the general rule of section 311(d), that a corporation recognizes gain on the distribution of property in redemption of stock. The exceptions are: (1) a distribution of assets to a 10% or more shareholder, in complete redemption of his stock held at least one year (section 311(d)(2)(A)); (2) a distribution of stock or debt of a 50% or more owned subsidiary (section 311(d)(2)(B)); (3) distributions in certain Sherman or Clayton Act proceedings (section 311(d)(2)(C)); and (4) certain distributions under the Bank Holding Company Act (section 311(d)(2)(G)).

B. Comments.

1. General. The Tax Section believes that a reduction in the scope of section 311(d)(2)(B) is called for. We do not believe, however, that it is necessary or desirable to repeal that section, and we see no reason for significant change in or repeal of sections 311(d)(2)(A) and (C) at the present time.

The issue of broadscale repeal of the section 311(d)(2) exceptions, as opposed to amendments merely to deal with perceived abuses, raises the fundamental question whether a corporation should recognize gain (or loss) on the distribution of its property to its shareholders.

Present law follows the rule of General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), which is codified in sections 311 and 336 of the Code. Under that rule, a corporation generally does not recognize gain or loss on property distributions to shareholders, whether as dividends, in redemption of shares, or in liquidation.

In 1969, Congress amended section 311 to provide for recognition of gain (but not loss) in certain corporate redemptions. At that time, the exceptions to gain recognition now at issue were enacted.* The impetus for the 1969 legislation was a perceived abuse--certain corporations, principally insurance companies, were using appreciated portfolio securities to retire stock.** The 1969 amendment did not constitute, nor would it appear that there was any intent that it should, a broad attack on the General Utilities concept, but was rather merely a narrowing of its scope.

It is apparent that one impetus for the Bill's proposal concerning section 311 is a particular perceived abuse. (See the discussion of section 311(d)(2)(B), below.) It may also be appropriate, at some point, to re-examine the fundamental concept involved, the General Utilities rule. We suggest, however, that the present Bill be confined to urgent changes to deal with abuses, and that the re-examination be done apart from the Bill, without the pressures attendant to a hastily conceived bill to raise critical revenues.

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* Section 311(d)(2)(G) was enacted in 1976.

** See, S. Rept. No. 91-552, 91st Cong., 1st Sess., at 279.

In that re-examination, Congress should focus on the extent to which a double-tax system is appropriate where corporate property is distributed to shareholders. The present rule--General Utilities--results in a partial integration system. The Bill's broadscale repeal of the section 311(d)(2) exceptions would move significantly away from that integration. That is a fundamental change which may or may not be desirable, but we see no good reason to put it into effect now, without thorough study and debate.

2. Section 311(d)(2)(B). The Tax Section believes that section 311(d)(2)(B) should not be repealed now, but should be narrowed so as to eliminate its availability in corporate acquisitions.

In a number of recent, well-publicized transactions, corporations have been able to dispose of subsidiaries to buyers which acquired the stock of the corporation with a view to a redemption exchange. Whether the disposition is a redemption exchange, and thus tax-free under section

311(d)(2)(B), has produced much debate.* Essentially, the issue, which is common to most transactions involving three parties (here, the corporation, the buyer, and the selling stockholders of the corporation), is whether (1) the subsidiary was transferred to the buyer for stock which it acquired from the selling stockholders, or (2) the subsidiary was sold to the buyer for cash which the corporation used to buy in its stock from the selling stockholders. Either construction is consistent with the end result, but under one construction the transaction is taxable to the corporation and under the other it is not.

We believe that the benefits of section 311(d)(2)(B) should be available only to historic shareholders of a corporation, not to persons which buy shares with a view to exchanging them for corporate assets. Accordingly, we believe that section 311(d)(2)(B) should be amended to provide that it does not apply to a redemption of stock held for less than two years.* We suggest two years because we believe that there is no doubt that a potential purchaser would not hold corporate stock (usually a minority position) for two years to obtain corporate assets, and that the corporation would likewise not want its shares to be held by that purchaser for so long a period.** As a result, a two-year holding period under section 311(d)(2)(B) would effectively preclude its use in a corporate takeover. More sweeping change than that is not warranted at present.

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* Compare Standard Linen Service, Inc., 33 T.C. 1 (1959) (acq.), with Idol v. Commissioner, 319 F.2d 647 (8th Cir. 1963), aff'g 38 T.C. 444 (1962). See also L.R. 8042140.

The suggested amendment of section 311(d)(2)(B) should also be accompanied by a provision to permit the distribution of a corporate subsidiary, otherwise qualifying under that section, to a diverse group of shareholders, where there is obviously no takeover context. An example is a distribution to all or most stockholders of a publicly-held corporation

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* Indeed, even one year might well be enough. As mentioned below (page 17), the one year holding period of section 311(d)(2)(A) seems to have prevented its use in takeover contexts.

** A provision should be included to the effect that stock held by a person that had a contractual right to exchange the stock for a subsidiary of the issuer would not be considered as being held for purposes of the holding period requirement.

(even a pro-rata redemption); in that example it would be difficult to establish the various holding periods of public shareholders so as to demonstrate compliance with the amended provision.

3. Section 311(d)(2)(A). We are not aware that section 311(d)(2)(A) has been effectively used as a takeover device.* On that basis, we would suggest that there is no need to repeal or alter the section. However, if our suggestion of a two-year holding period under section 311(d)(2)(B) is adopted, it would seem logical to have the same holding period established for section 311(d)(2)(A).

4. Section 311(d)(2)(C) and (G). The distributions involved in section 311(d)(2)(C) are not used in corporate takeovers. Moreover, they are essentially involuntary transactions arising under the antitrust laws. We see no reason to eliminate that exception in the context of a bill to make the tax law neutral as to corporate takeovers.

As to section 311(d)(2)(G), involving distributions under the Bank Holding Company Act and section 1101 of the Code, such distributions would not occur after December 31, 1980 and the elimination of section 311(d)(2)(G) therefore appears appropriate.

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* That is because of the one-year holding period requirement in the section. See Rev. Rul. 80-221, 1980-2 C.B. 107, for an attempt to use section 311(d)(2)(A) in a takeover context. The attempt was not successful.

5. Partial Liquidations; Spin-offs. We discuss partial liquidations more generally in IV, below. We note here, however, that the tightening of section 311(d)(2) would also call for tightening of partial liquidations and section 355 transactions.

Assuming for the moment that the partial liquidation provisions are not repealed (as is our recommendation), it would be necessary to prevent a buyer from acquiring corporate stock to be surrendered in a partial liquidation (tax-free to the corporation under section 336) for a desired corporate asset. Indeed, the Standard Linen case itself involved that kind of partial liquidation. We suggest that the same two-year holding period as is suggested under section 311(d)(2)(B) requirement be added in the partial liquidation context to confine the use of a partial liquidation to historic shareholders.

As to section 355, we believe that attention should be given to the question whether corporate assets can be acquired, in a takeover context, on a tax-free basis using the tax-free spin-off provisions. For instance, it is at least arguable that section 355 could be applicable to the distribution of a 100% owned subsidiary to a stockholder in redemption of its stock, even though such stock was recently acquired for cash in order to be used in the redemption. If section 355 does apply, then there would be no tax to the distributing corporation, even if the recommended amendments were made (or if the Bill's provisions were enacted in toto) with respect to sections 311 and 346. Accordingly, Congress should prevent section 355 from being used as a corporate takeover vehicle just as sections 311(d) and 346 could be used. The failure of the Bill to cover that point is an excellent example of why legislation in the complex area of Subchapter C should be undertaken only with deliberate care, and not as part of an intense, accelerated revenue-raising package.

IV. Partial Liquidations.

A. Description of Bill. The Bill would repeal the partial liquidation provisions of section 346 of the Code, and amend section 302 of the Code so as to permit sale or exchange (capital gain) treatment to a shareholder in certain transactions now qualifying as partial liquidations.

C. Comments.

1. General. The partial liquidation provisions of the Code have been used in certain recent takeovers. We believe that there is one significant loophole in the present scheme (the elimination of investment credit recapture under the Consolidated Return Regulations) which

should be closed, and that a case could be made that there is another possible loophole (deferral of depreciation and other recaptures under such Regulations) which might well be closed. Beyond that, we do not believe that it is clear that any change in law is warranted.

2. Investment Credit Recapture. Under present regulations, the distribution of assets in a partial liquidation to a corporate shareholder does not result in investment credit recaptures if the parties file a consolidated tax return. We believe that, in a takeover context, i.e., where the credits were earned before affiliation, that is clearly wrong and that the Consolidated Return Regulations should be amended prospectively or that a legislative override of the Regulations should be enacted.

3. Depreciation Recapture. Under present regulations, the distribution of assets in a partial liquidation in a consolidated return situation is a deferred intercompany transaction, so that income recaptures are recognized, but deferred and restored (i.e., added to income) as the basis step-up is used by the distributee. Where the item being recaptured (e.g., depreciation) was earned prior to consolidation, it is arguable that deferral is inappropriate. (Deferral is certainly appropriate to the extent

the item was earned during, rather than before, consolidation.) On balance, we would recommend that the Consolidated Return Regulations be amended, prospectively, to eliminate deferral for recapture of pre-affiliation items, or that a similar legislative override be provided.

4. Other Changes. It is arguable that, in a consolidated (or even in any intercompany) situation, basis step-up to a distributee corporation should not occur selectively (i.e., in a partial liquidation) at all. The argument would be that section 334(b)(2), which presumes a complete liquidation, should be the exclusive route to a step-up in basis, and that in a mere partial liquidation, the corporate parties, both distributing corporation and distributee corporation, should be treated the same as if the assets were not distributed in liquidation, but instead under section 301 of the Code. (That would result in basis carryover, not step-up.)

Such a rule could be adopted by regulation if it were confined to corporations filing consolidated returns, but the logic of the rule would seem applicable to all intercompany situations, whether consolidated returns are filed or not. That suggests a legislative solution.

We take no position whether the foregoing rule should be adopted. The consolidated return recapture rule changes recommended in paragraphs 2) and 3), above, may be adequate to deal with corporate takeover problems in the partial liquidation context. We do feel strongly, however, that there is no good reason to repeal the partial liquidation provisions as applicable to distributions not in an intercompany context.* We recommend that section 346 be retained in its present form for distributions other than to 80% corporate shareholders. Thus, section 336 would still prevent recognition of gain to the distributing corporation in such a partial liquidation. The section 302 amendment would be unnecessary in that event.

We note that under proposed new section 302(a) (section 101(c) of the Bill), it might be necessary to have an actual stock redemption in order for the section to apply. That is the rule under section 302, although the rule under section 346 is different.** If proposed section 302(e) is enacted, it should be made clear that the rule of Fowler Hosiery will apply.

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* Among other situations in which it is appropriate to retain section 346 is that of a family or other dispute among shareholders, and resulting division of a business (not qualifying under section 355).

** See Fowler Hosiery v. Commissioner, 301 F.2d 394 (7th Cir. 1962); Rev. Rul. 79-257, 1979-2 C.B. 136; Rev. Rul. 81-3, 1981-1 C.B. 125.

V. Effective Dates.

A. Description of Bill. The provisions of the Bill relating to sections 338 and 334(b)(2) apply to acquisitions occurring after August 31, 1982. The amendments to sections 331 and 346 apply to distributions after that date.

B. Comment. The Tax Section believes that the foregoing August 31 effective date should be changed to the later of the date of enactment or December 31, 1982. As a general matter, we think that the effective dates in the Bill should not be so soon as to disrupt pending transactions which were planned and as to which there has been reliance, including the incurrence of transaction costs, on existing law, at least where the result under current law was acknowledged by the government. For instance, the consolidated return treatment of recaptures in a partial liquidation is clear under the regulations and the Internal Revenue Service (the "Service") has issued frequent favorable rulings on the subject.* Transactions may be pending which will not close by August 31, but which were planned based on those authorities and pursuant to which taxpayers have incurred substantial costs. It would be unfair for the effective date of Title I of the Bill to be so soon as to apply to such transactions.

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* See, *e.g.*, L.R. 8204064.

As to the section 311 amendments (i.e., the essential amendment to (or repeal of) section 311(d)(2)(B)), the corporate takeover technique involved is obviously not clearly permitted by the Service and may well be challenged by it. On the other hand, the correct result is by no means clear and may vary from case to case depending on the facts. Under the circumstances, we believe, the effective date should permit existing law (as to which no inference should be drawn from any amendment to section 311) to apply to transactions which are closed before 1983.

As to section 338, a prompt effective date would not be objectionable if the section only applied (as we strongly recommend) to the Target Corporation and those subsidiaries elected by the purchaser. Extension of section 338 to all subsidiaries, however, would in fairness call for a more delayed effective date. Parties could be substantially committed to many transactions (although there might not technically be binding contracts) in contemplation of existing section 334(b)(2), and if section 338 is to apply to subsidiaries, such transactions should be permitted to close based on existing law. We therefore recommend that the effective date of section 338 be December 31, 1982, rather than August 31, 1982, provided, however, that a transaction which is substantially binding on the parties (apart from customary closing conditions, such as financial condition, updating of warranties, third party consents and approvals, etc.) on July 1, 1982 be permitted to close after 1982 under existing law.

Senator DANFORTH. Gentlemen, thank you very much.

Senator Specter is here to testify on this bill, and I would like to hear from you, Senator, and then we have three more panels.

Thank you, Senator Specter, for being with us.

STATEMENT OF HON. ARLEN SPECTER, U.S. SENATOR, STATE OF PENNSYLVANIA, ACCOMPANIED BY WILLIAM WILCOX

Senator SPECTER. Mr. Chairman, I very much appreciate this opportunity to testify in support of S. 2224 which would establish a national version of a program which has been put into effect successfully in many States on the concept of the neighborhood assistance program for job training, to allow a credit of 20 percent against contributions to programs providing job training for specific classes of individuals such as those displaced from their other work, like steelworkers or economically disadvantaged or handicapped.

I have submitted a statement for the record, and I intend to speak very briefly at the moment and to summarize it in terms of what I consider to be the highlights of the proposal.

Pennsylvania enacted the first of the State business tax credit programs in 1967, and a number of other States, including Missouri, have enacted similar programs. The States cover Indiana, Delaware, Michigan, Florida, and Virginia.

The program, in my judgment, as it has been applied in Pennsylvania is an excellent program. On February 23 of this year I visited an academy at the old Northeast High School in Philadelphia which has utilized this program with great success. Following that visit, under the direction of my deputy, William Wilcox, who is with me here today, we have structured the legislation we have introduced.

Bill Wilcox served as Secretary of Community Affairs for the Commonwealth of Pennsylvania for some 6½ years in the Shapp administration starting in 1971; and the Department of Community Affairs was the unit that was responsible for the administration of this program, and he has very detailed knowledge which has led him to lead me to present this legislative proposal.

With the heavy volume of legislation which was introduced in the Senate, it is a difficult matter to get hearings and to get a focus of attention on such matters. And I advanced this bill as an amendment to the Quayle-Kennedy bill 2 or 3 weeks ago, and withdrew the amendment on the assurance of the hearing today. And as matters are considered in the Senate, it is difficult to get our colleagues to focus attention on them in the face of consideration that there have not been hearings which have been held. So I very much appreciate this opportunity for the hearing, and it has focused the attention of the Treasury Department so that they have given reasons in opposition to the bill which we had not been able to get a focus of their attention prior to the time that this hearing was scheduled.

The issues which they have raised I think can be dealt with in most situations. They have raised an objection that the benefits would go for job training where there was no assurance that jobs would be available, and that is an objection which I think has a foundation, and there can be a modification to take that consideration into account.

When they talk about the preference for tax credits for the Federal assistance to promote jobs for disadvantaged individuals and the approach of targeted jobs tax credits they say is generally preferable to the approach of this bill, I would submit that this bill has a fundamentally different approach in an area where there is really a tremendous need.

Where they talk about the consideration of the date, that is subject to a modification. So I think that a number of their objections can be dealt with, and I would want to have an opportunity to review the issues which they have raised in some greater detail, since they did not file it until 9:30 this morning, and I did not have any advance notice of it and would want to have an opportunity to consider these issues in some greater detail.

But the essential consideration, Mr. Chairman, of the issue of job training so that people can be redirected toward their work is a matter of overwhelming, enormous importance in this Nation today, something that hardly needs to be said. It has gripped my State more acutely than most where Pennsylvania is No. 2 in the unemployment hit parade, and in an industry like steel there is an enormous need to have retraining for new jobs.

From what I have seen of this program in this old high school in North Philadelphia which is taking blacks off the unemployment rolls and putting them to work for Philadelphia Electric, it is an enormously compelling need. I think this program goes right to the heart of that need.

There are a number of witnesses who will be appearing this afternoon. We have worked hard to try to bring in people who know this program and know how it has worked to provide insights for the committee and the record which can be considered by the Senate as a whole.

I would ask leave at this time for just a moment or two, Mr. Chairman, to hear from Bill Wilcox, who had administered this program at some length, to give some view of his interest, his knowledge, and his intensity, which I think goes a long way in explaining my very special push on this bill.

Senator **Danforth**. Mr. Wilcox, we are glad to have you here.

Mr. **Wilcox**. Senator, this program was developed in the 1960's in part as a reaction to the civil unrest in Pennsylvania, and it has spread, as Senator Specter indicated, to a number of other States, and the experience has been universally satisfactory with it.

You will be hearing this afternoon from Mr. Johnson of Missouri who administers the program in that State. Basically, a corporation or nonprofit organizations are given a tax credit allocation by the State department of community affairs—$8.75 million a year in Pennsylvania—and then these nonprofit corporations seek contributions from businesses in their area to support a program with the understanding that these tax credits will be made available to them. And a large part of the $8.75 million, which is authorized each year by the general assembly, is actually used for fundraising purposes.

The States traditionally have covered a number of areas besides job training: Community development, health issues, and a large number of other services. S. 2224 is different in that respect from the State programs because it is limited to job training. In another respect S. 2224 is a bit broader than the State programs because it can be applied in areas which are not considered disadvantaged areas, and that is important for the reason that Senator Specter touched on—the high amount of unemployment which is going to continue on after this recession has lifted. That can be called technological unemployment or unemployment due to displaced persons.

I think that summarizes the information that I have.

Senator **Danforth**. Thank you.

Senator **Specter**. Mr. Chairman, I know the burdens you have here past noontime with so many issues to be heard, so we have been calculatedly brief in our presentation. I would like to add just a couple of notes.

One is that in having Mr. Johnson from Missouri appear here, we did not know that Senator Danforth would be chairing these hearings, so it was not by prearrangement. He happens to be uniquely qualified by experience to touch on this subject.

Where the Treasury statement says in its concluding paragraph, "Finally, the tax credits provided by S. 2224 will add complexity to the Federal tax law and will decrease Federal revenues," I cannot help but say that that would apply in most measures that are presented to this committee.

I was interested to see their particularization as to what this program would cost—that is what a Senator cannot find out easily until there is a hearing like this—and the sums of money in the overall schemes of things are relatively modest, being $51 million in 1983, $41 million in 1984, and so forth, which makes me think that this is a good kind of an experimental program to have to see what would be produced by way of company corporate contributions and how it would be directed toward blacks or former steelworkers or disadvantaged, and how many jobs would be available. Its success in so many States I think merits its attention at the Federal level; and I am encouraged by the kind of cost figures which are set forth here.

In conclusion, let me add a personal note. This is the first time I have had an opportunity to walk into the Finance Committee hearing room, and I find it very impressive, and it is very nice to be a part of such a proceeding and to have listened, albeit briefly, to the last panel discuss the complexities of the Internal Revenue Code, which reminded me of some of the experiences that I have had, albeit somewhat limited, in the tax field.

And I want to compliment the committee for wrestling with these very complex issues in an unenviable job to sift through the proposals which come to the Senate and to make the recommendations and to do the job which this committee has done really with exceptional success, especially the herculean task accomplished in 8 days to present the legislation on the tax bill which is being considered next week.

Senator DANFORTH. Senator Specter, thank you very much. Mr. Wilcox, thank you.

Senator Specter, I appreciate your leadership in this area. Clearly, training people and retraining people to do work in modern times is essential to the economic future of our country. And this is something we have wrestled with in the field of trade adjustment assistance and other areas, and I can assure you that your bill will be considered here.

Thank you, and thank you, Mr. Wilcox.

Next, we have a panel consisting of John Fitch, Hart Spiegel, and Stewart Dunn.

[The prepared statement of Senator Arlen Specter follows:]

ARLEN SPECTER
PENNSYLVANIA

APPROPRIATIONS
VETERANS' AFFAIRS

United States Senate
WASHINGTON, D.C. 20510

SUMMARY OF STATEMENT OF SENATOR SPECTER ON S. 2224

U.S. SENATE COMMITTEE ON FINANCE
JULY 15, 1982

1. Many states, including Pennsylvania, provide state tax credits to encourage job training and community development programs.
2. An unusually good program of job training has been developed in Philadelphia using the State tax credit program.
3. Local interests would be directly involved in developing job training programs under S. 2224.
4. America is in a transitional phase regarding jobs, more job training is needed.
5. There is a large amount of structural unemployment at this time.
6. S. 2224 is consistent with administrative objectives, including emphasis on local initiatives and on enterprise zones.

STATEMENT BY UNITED STATES SENATOR ARLEN SPECTER
BEFORE THE UNITED STATES SENATE
COMMITTEE ON FINANCE
ON S. 2224

Mr. Chairman, it has been said that the states should be governments which experiment with programs which, when proven successful, can be adopted as national programs. S. 2224, a bill we review today, actually has been tested successfully in Pennsylvania and other states. Pennsylvania enacted the first of these state business tax credit programs, called neighborhood assistance programs, in 1967, and during the next decade, Indiana, Missouri and Delaware followed suit. More recently, Michigan, Florida and Virginia began a similar use of tax credit incentives on state business taxes to promote job training and community development and to improve living conditions. As recently as this spring, Wisconsin passed legislation providing tax credits to enhance the financing of economic development projects operated by community organizations. And at least twenty-two other states are considering tax incentive measures focussing specifically on the needs of distressed neighborhoods and communities.

Although these tax incentive programs vary from state to state, the enabling statutes are generally referred to as Neighborhood Assistance Acts (NAAs) and the resulting activities are known as Neighborhood Assistance Programs (NAPs). The evident popularity of the Neighborhood Assistance Tax credit approach lies in its operational simplicity. In the typical program, a business receives a tax credit under state law for investing in or contributing to approved projects which improve economic and social conditions in low-income central city neighborhoods or rural areas. Activities for which tax incentives are provided include a variety of services, as well as job training.

Undoubtedly, the popularity of the Neighborhood Assistance tax credit has been enhanced by the diminished federal support for community development. The demise of government programs compels greater attention to private sector sources of funds if such activities are to continue at an appreciable level. NAP is designed to elicit such support by lowering the after-tax effective cost of participation. The resulting investment can directly support a project, or it can be a non-federal match for Federal or State assistance. In fact, when a corporate contribution is made under a state neighborhood assistance program, I understand there is a slight revenue gain to the Federal treasury.

For example, Philadelphia area businessmen and civic leaders have been encouraged by the Pennsylvania Neighborhood Assistance to contribute to three high school academies training young people in applied electric science, automobile repair, and business skills. Students who at the time of enrollment often show less than average promise are provided this specialized training at public high school sites.

Business leaders believe this program is an important Philadelphia job training activity. Many students thought to be below average achievers have developed during the training highly marketable job skills. Drop out rates are a fraction of those of regular high school programs and the graduation rate is double. The involvement of local businessmen in the nonprofit corporations operating the program has helped assure placement opportunities for those who complete the program. Over 90 percent of the graduates are placed in jobs. The nonprofit corporations operating these three programs do not accept grants from public agencies. On Febrary 23 of this year, I personally visited the electric academy and observed the school in operation. I was much impressed with what I saw. Other witnesses will tell you more about this program.

S. 2224 would establish a similar, though considerably more limited, national version of the Pennsylvania neighborhood assistance program for job training to allow a credit of 20 percent against contributions to programs providing job training for handicapped and economically disadvantaged individuals. This credit, plus the already authorized Federal deduction, in most cases will represent about a one third net cost to the contributing corporation.

Each training program would be developed by qualified nonprofit organizations and certified by the regional Office of Employment and Training Administration of the Department of Labor as providing job training solely to handicapped persons, economically disadvantaged individuals, or workers with obsolete skills. Private corporations would contribute the training funds. Unlike most programs of this type, there are virtually no administration costs to the Federal Government and all of the contributed funds remain in the local community. There is no expensive corps of Federal bureaucrats to take a cut from these funds as they flow from the community to Washington and back again. Under my proposal, they never leave the local community.

The maximum credit available for any single corporation is $250,000; thus the program is especially supportive of training efforts by small -- and middle-sized businesses. The Administration can regulate the revenue impact by controlling, through the Department of Labor, the number of approved applications. The National Economic Development and Law Center estimates that "the state experience (with this program) suggests that the costs of a Federal program would be relatively modest."

There is little doubt that America is in a transition phase from heavy industry to high technology, thus many skilled and dedicated workers are losing their jobs because of technological obsolescence over which they have little control.

On March 16, the Pittsburgh Post-Gazette carried a news story "No One's Safe, Steel Layoffs Still Growing; White Collar Workers Also Hit." On the same day, the Wall Street Journal headlined "Pittsburgh's Recession Shows How Layoffs Ripple Through Economy."

Mr. Chairman, On July 8, The Washington Post, in a headline reported "Audiences at Political Forums Want Candidates to Talk

About Employment and Training," earlier this week, on July 12, it read "Thousands of Blue Collar Jobs are Lost Forever in Recession." Thus, we all know a terrible truth: When the current recession lifts, and lift it will, we will find that many Americans who are unemployed will remain unemployed. They will remain unemployed simply because the blue collar jobs they once held have disappeared. In short, the current recession has masked much structural unemployment. S. 2224 is a means to retrain these so-called structurally unemployed; and to do this retraining through local initiative and design.

While job training does not, of itself, create jobs, it will retrain skilled workers for the new jobs as we create new jobs in the economy, as create we must for our American work force.

Mr. Chairman, S. 2224 will encourage the private sector to sponsor the job training and retraining programs for these workers, as well as for disadvantaged and handicapped citizens.

I suggest this bill can be an important part of the overall job training efforts of this Nation. With the Administration's proposal for enterprise zones this can integrate effectively with that economic uplift plan. New industry will need new trained employees and this amendment provides a vehicle for local planning, development, and administration of job training. Thus, it is consistent with the concept of enterprise zones. It is consistent with the Administration's support for local initiative and planning. It can also encourage job training in areas which are not designated as enterprise zones, as well as those which are.

I urge this committee report favorably S. 2224.

Senator DANFORTH. Mr. Fitch, would you like to begin?

STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS, WASHINGTON, D.C.

Mr. FITCH. Thank you, Mr. Chairman.

I will briefly run through my statement and give our view (which is similar to Don Alexander's) on the impact this legislation has on closely held corporations.

We oppose the provisions as they are currently written for the following reasons: one, that under current law, shareholder stock redemptions for corporate assets is a nontaxable event to the corporation but a gain to the shareholder. Under the Senate finance provisions, as I understand it, the transaction would now be taxable to the corporation as well.

Further, under current law, total redemption of shareholder stock by a corporation under certain conditions would still be considered a partial liquidation, and again, only taxable as a gain to the shareholder. The Senate finance provision would consider that a total liquidation and taxable to the corporation as well.

Moreover, an aspect that has not been discussed but one I want to bring up at this point is that if a corporation was using LIFO method of inventory valuation, the total liquidation provision contained in the Senate finance proposal would also trigger the LIFO reserve recapture provision of section 336, which would in effect be a triple taxation.

Double taxation in the best of times is difficult to justify, but triple taxation, in our view, is irresponsible and totally impossible to comprehend. We believe that this provision is throwing the baby out with the bathwater. For the small, family owned, closely held wholesaler, this type of tax policy spells economic ruin. Add to that the current economic environment, and its chances for survival are very small. With high interest rates and effective tax rates already severely strangling cash flow and profitability, his view is "with friends like this, who needs enemies?"

While NAW understands the situation under which this package was put together, we strongly urge the Finance Committee to reconsider its position on this provision and either modify it to address only the perceived abuses in tax-related mergers and acquisitions or leave the sections alone, or at a minimum, exempt closely held corporations from its application.

To further reduce this tax burden, we also urge the committee to repeal the LIFO reserve recapture provision of section 336 of the code. This provision falls heaviest on inventory-intensive businesses such as wholesalers and retailers who utilize the LIFO method 0f inventory valuation for tax purposes. Moreover, this tax burden falls heaviest on smaller firms whose primary means of liquidation is by asset sale under sections 336 and 337 of the code.

To single out closely held firms on the LIFO method of inventory valuation is counterproductive, inequitable, and unfair.

Lastly I would like to comment on Mr. Glickman's solution to the closely held small business problem under this provision. In my view his solution is even more complex than current law and would require more sophisticated tax planning and increased legal and accounting fees related to that—something small business at this point can hardly afford.

Mr. Chairman, I think that that would merely increase their frustration with the Tax Code as well as with the Federal Government.

In conclusion, we would like to express our admiration to you and the rest of the committee for its work in developing a revenue package under the most difficult of circumstances. We believe it to be well-balanced, fair and equitable. Even though we are opposed to tax increases as a means of reducing the Federal deficit—we think spending cuts is the appropriate way to do it—we do not oppose the package as a whole.

As with the corporate merger provision, other provisions of the revenue package are extremely complex and have far-reaching effect on capital formation, particularly for closely held businesses, that their presence in the package merely as a means to raise revenue is extremely short-sighted and poor tax policy.

However, having said that, the circumstances under which this package was formulated were not ordinary by any means, and we understand that also quite as well.

Thank you very much.

[The prepared statement of John H. Fitch, Jr. follows:]

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

STATEMENT OF

John H. Fitch, Jr.

Vice President - Government Relations

INTRODUCTION

Mr. Chairman, Members of the Committee, this statement is presented on behalf of the wholesale distribution industry by the National Association of Wholesaler-Distributors. My name is John H. Fitch, Jr., Vice President-Government Relations for NAW.

The National Association of Wholesaler-Distributors is a federation of 121 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business (see attached list).

The members of our constituent associations are responsible for 60% of the $1.4 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade.

Although the individual firms which our organization represents are small- to medium-sized businesses individually, their collective economic importance is most significant.

THE INDUSTRY (see attached data sheet)

The wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely-held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99% had assets of $10 million or less. These smaller firms accounted for about 58% of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2% of the firms controlled about 88% of the assets and accounted for approximately 80% of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. In 1977, average hourly earnings ($6.78) in wholesale trade exceeded those for all private industry ($5.14), while average weekly earnings ($212) were 15% above those in private industry ($185). In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

A 1981 profile of the wholesale trade, as compiled by the U.S. Department of Commerce from Census Bureau figures, shows the following:

SIC CODES: 50-51	
Sales (million $)	1,218,384
Employment (000)	5,412
Number of establishments (1977)	307,264
Compound annual rate of change, 1975-80:	
Sales (percent)	12.3
Employment (percent)	3.6
Payroll (million $)	72,000

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

FULL STATEMENT

Mr. Chairman, NAW opposes the corporate merger or provision contained in the Finance Committee's FY 1983 Budget recommendation revenue package as it is currently written.

We base this position on the following reasons:

(1) Under current law, a shareholder stock redemption for corporate assets is a non-taxable event to the corporation, but is a capital gain to the shareholder.

Under the Senate Finance provision as we understand it, such a transaction would now be taxable to the corporation as well.

(2) Under current law, a total redemption of a shareholders stock by a corporation would be considered a partial liquidation and again only taxable as a gain to the shareholder.

Under the Senate Finance Committee provision, such a transaction would be considered a total liquidation and taxable to the corporation as well.

Moreover, if the corporation was using the LIFO method of inventory valuation, such a transaction would also trigger the LIFO reserve recapture provision.

Double taxation in the best of times is difficult to justify, but triple taxation is irresponsible and totally impossible to comprehend!

For the small, family-owned, closely-held wholesaler, this type of tax policy spells economic ruin. Add to that the current economic environment and his chances for survival are nil.

With high interest rates and high effective tax rates already severely strangling cash flow and profitability, his view is "With friends like this, who needs enemies!"

While NAW understands the situation underwhich this package was put together, we strongly urge the Finance Committee to reconsider its position on this provision, and leave sections 311, 333, 336 and 337 as they are; or at a minimum, exempt non-publicly held corporations from the provision contained in your revenue package.

To further reduce this onerous and inequitable tax burden, NAW also urges the Committee to repeal the LIFO reserve recapitulation provision of section 336 of the code.

This provision falls heaviest on inventory intensive business such as wholesalers and retailers who utilize the LIFO method of inventory valuation for tax purposes. Moreover, this tax burden falls heaviest on smaller firms whose primary means of liquidation is by asset sale under sections 336 and 337 of the code.

To single out closely-held firms, as the LIFO method of inventory valuation does, is counter-productive, inequitable and unfair.

They are the least able to bear the burden of taxation, and the most likely to liquidate under these provisions generally.

Repeal of this provision is not only extremely important for the survival of small business in today's economic climate, but also it makes good tax policy sense.

Finally, it may be useful to review for the Committee the history of Section 337 of the code, and its implication for small business.

Section 337 of the Internal Revenue Code of 1954 (complete liquidation pursuant to a plan within a twelve month period) has served small business well. Prior to its adoption, the tax aspects of a given transaction rested on very fine factual determinations best illustrated by the Court Holding Co. and Cumberland Public Service Co. cases.

In Commissioner v. Court Holding Co., a corporation negotiated the sale of certain real property it owned. An oral agreement was reached with the buyer, but when the contract was to be signed, the buyer was advised that the sale could not be consummated because of the tax situation of the corporation. The next day the corporation liquidated and the shareholders of the corporation received the corporate assets. A sales contract was then drawn between the shareholders and the buyer on essentially the same terms and conditions as were previously agreed upon. One thousand dollars which had been paid to the corporation by the buyer earlier was applied to the payment of the purchase price. After reviewing these facts, the Supreme Court affirmed the Tax Court's decision that the executed sale was in substance a sale by the corporation.

Contrast the Supreme Court's decision in Court Holding to Cumberland Public Service Co., where a sale of property by shareholders that they had received in a liquidating distribution was not attributed to the corporation.

The distinction between Court Holding and Cumberland was purely factual. The triers of fact in the Court Holding case found that the purpose of the so-called liquidation was to disguise a corporate sale through the use of mere formality; and the triers of fact in the Cumberland case found that the shareholders did not act as mere conduits for a sale by the corporation involved.

Congress described the state of the law prior to the enactment of Section 337 as a trap for the unwary. Congress, by enacting Section 337 in the 1954 Code, eliminated the fine distinction that had to be made, if indeed one could be made, under the Court Holding and Cumberland doctrines.

Small business was and is today entitled to the relief of Section 337. Unlike their publicly traded cousins, shares of a closely held business have no ready market even to a prospective purchaser of the business. Without the availability of the advantages of an asset purchase, small business will be required to assume another burden that will further depress its marketability and discourage its formation.

Section 337 grants stability to the transfer of small business interests by providing predictability. Take away or impair that predictability and small business will be forced back into the confusion that existed prior to the enactment of 337.

The sale of small business structured as an asset purchase has been more widely used than the purchse of a small business corporation's shares. The termination of liability for past actions and the elimination of a great deal of cost and time substantiating the accuracy of corporate financial and other records as a consequence of a stock acquisition are but a few of the advantages to both the seller and buyer through an asset purchase of a small business.

Section 337 did not adversely affect the revenue. Prior to its enactment, Section 337's tax effect was determined by a series of complex Court Holding or Cumberland type of dissolutions or maneuvers.

In summary, Section 337 and its related Section 333 dissolution is vital to the continued vitality of small business. Tampering with its provisions will not benefit small business or the Treasury.

In 1980, Congress enacted the Windfall Profit Tax on Domestic Crude Oil. A section of that Act provided that a small business LIFO reserve would be considered income to the business upon the sale of inventory in an asset sale of a business entity.

Special attention should be given to the recapture of LIFO reserve in a Section 337 liquidation. The courts, when faced with the issue, have consistently held that the LIFO reserve did not take on the attributes of income, and a corporation did not realize income upon the sale of a LIFO inventory to the extent of the LIFO reserve. Treasury, in its continuing effort to penalize small business adopting LIFO, would have a 337 liquidation trigger a taxable incident to the extent of the LIFO reserve. Congress should take this opportunity to eliminate that onerous burden for small business and facilitate the free transfer of small business interest and promote the establishment of new small business ventures.

CONCLUSION

In conclusion, Mr. Chairman, NAW would like to express our admiration to you and the Committee for its work in developing a revenue package under the most difficult of circumstances.

We believe it to be well-balanced, fair, and equitable. While NAW is opposed to tax increases as a means of reducing the federal deficit (we believe in further significant cuts in federal spending is the most effective method), we do not oppose the package as a whole.

As with the corporate merger provision, other provisions of the revenue package, such as the FUTA tax increase, the pension "reform", the IDB "reform", accelerated corporate payments, basis adjustment and ACRS scale back, are so complex and have such a far reaching affect on capital formation, that their presence in the package, merely as a means to raise revenue, is extremely short-sighted and a poor tax policy.

However, having said that, the circumstances under which this package was formulated were not ordinary by any means and we understand that quite well.

Mr. Chairman, that concludes my statement, I'd be happy to answer any questions.

United States
Wholesale Distribution Industry
Summary Statistics by State[1]

I. National	Establishment (Number)	Sales ($000's)	Average Sales $ Per Establishment	Payroll ($000's)	Employees (Number)
Wholesale Trade	382,837	1,256,400,268	3,287,039	58,289,573	4,397,089
II. State					
Alabama	5,713	14,185,813	2,483,076	705,379	63,548
Alaska	649	1,562,699	2,407,857	115,905	6,232
Arizona	3,587	8,091,848	2,255,862	470,913	39,139
Arkansas	3,665	6,769,264	1,847,002	361,855	34,023
California	36,704	128,628,351	3,504,478	6,334,251	448,808
Colorado	5,457	15,617,678	2,861,953	790,751	60,824
Connecticut	4,694	19,233,684	4,097,504	811,741	59,102
Delaware	770	5,155,611	6,695,599	192,376	12,441
District of Columbia	594	2,154,745	3,627,517	169,063	10,866
Florida	15,409	34,380,491	2,231,195	1,822,284	156,901
Georgia	10,085	35,213,332	3,491,654	1,462,358	118,161
Hawaii	1,569	2,571,469	1,638,935	177,556	14,695
Idaho	2,037	3,194,237	1,568,108	210,537	20,338
Illinois	21,237	97,080,216	4,574,021	4,207,197	280,312
Indiana	8,875	25,439,511	2,866,424	1,223,642	97,402
Iowa	7,646	20,078,789	2,626,051	825,097	68,559
Kansas	5,349	17,460,965	3,264,342	652,573	53,949
Kentucky	5,133	13,485,315	2,627,180	646,720	56,075
Louisiana	6,800	19,568,473	2,877,717	955,683	81,238
Maine	1,580	2,830,910	1,791,715	177,823	16,725
Maryland	5,019	16,900,800	3,367,364	902,244	67,121
Massachusetts	9,107	30,235,785	3,320,060	1,549,866	113,072
Michigan	12,527	45,151,519	3,591,435	2,108,920	141,484
Minnesota	8,625	29,092,203	3,373,009	1,283,969	94,320

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[1] Compiled by the National Association of Wholesaler-Distributors from 1977 U.S. Census of Wholesale Trade

United States
Wholesale Distribution Industry
Summary Statistics by State[1]

I. National	Establishment (Number)	Sales ($000's)	Average Sales $ Per Establishment	Payroll ($000's)	Employees (Number)
Mississippi	3,592	6,980,066	1,943,225	380,486	36,156
Missouri	10,007	35,080,391	3,511,149	1,519,797	115,784
Montana	1,815	2,968,857	1,635,734	162,348	14,176
Nebraska	4,164	10,648,164	2,557,196	494,245	42,273
Nevada	995	1,747,881	1,756,664	126,617	9,467
New Hampshire	1,223	2,024,293	1,655,186	147,703	12,007
New Jersey	12,997	55,327,312	4,256,929	2,651,785	182,023
New Mexico	1,969	2,714,261	1,378,497	192,127	17,297
New York	38,149	165,380,274	4,335,114	6,115,472	410,502
North Carolina	9,571	27,513,222	2,874,644	1,253,867	107,777
North Dakota	2,126	3,889,871	1,829,667	195,510	16,981
Ohio	16,643	61,702,900	3,707,439	2,927,562	212,354
Oklahoma	5,488	13,420,256	2,445,382	638,877	53,447
Oregon	4,904	18,085,350	3,687,877	765,363	54,312
Pennsylvania	17,536	53,711,351	3,067,995	2,817,940	211,479
Rhode Island	1,480	3,075,704	2,078,178	206,420	16,803
South Carolina	4,112	8,265,612	2,010,120	461,821	41,859
South Dakota	1,897	3,401,448	1,793,067	162,051	15,433
Tennessee	7,406	29,277,435	3,953,205	1,127,124	92,501
Texas	26,370	87,681,954	3,325,065	3,853,446	309,616
Utah	2,301	5,361,938	2,330,264	327,991	26,561
Vermont	746	1,036,523	1,389,441	75,025	7,066
Virginia	6,254	19,088,402	3,052,191	955,166	79,315
Washington	7,091	19,852,195	2,799,633	1,084,836	76,615
West Virginia	2,372	4,492,662	1,894,040	299,671	25,317
Wisconsin	7,874	19,648,057	2,495,308	1,111,980	86,408
Wyoming	879	1,940,161	2,207,237	75,540	6,131

For further information on the wholesale distribution industry and the National Association of Wholesaler-Distributors, write: NAW, 1725 K Street, N.W., Washington, D.C. 20006; or call: 202/872-0885.

NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS
1725 K Street, N.W. • Washington, D.C. 20006 • 202/872-0885

Senator **Danforth**. Thank you, sir.
Mr. Spiegel.

STATEMENT OF HART H. SPIEGEL, TAX COUNSEL, NEWHALL LAND & FARMING CO., VALENCIA, CALIF.

Mr. **Spiegel**. Thank you, Senator.

My name is Hart H. Spiegel. I am a partner in the lawfirm of Brobeck, Phleger & Harrison in San Francisco. I have been actively engaged in the practice of tax law for 35 years. I served as Chief Counsel for the Internal Revenue Service from 1959 to 1961, and I believe I have some appreciation of the need for periodic tightening or modification of the tax law. But I associate myself with Don Alexander, John Nolan, Mr. Camp, and the others who have been here in urging that this legislation, while laudable in its goals, is too broad, that it is aimed at particular problems but has disastrous side effects which catch up innocent parties in the net.

I should like to address the problem that Senator Danforth expressed interest in. The Senator has said that we are trying to get at the publicized cases, the United States Steel-Marathon, the Esmark-Mobil, the Richfield-Anaconda type of case where a giant corporation has moved in and bought a portion of the stock of the corporation and has used the partial liquidation or the redemption sections of the code to facilitate the takeover at a minimum tax cost.

I do not dissent from the Senator's interest—and the committee's interest—in trying to forestall that sort of maneuver. In fact, I endorse it.

The minor premise of the committee is that in order to stop this sort of thing, we have got to put an end to partial liquidations and these redemptions. To me, that minor premise or conclusion, really, is broader than it needs to be. All partial liquidations need not be terminated merely because some, which are associated with a takeover endeavor, are bad.

Now, the Treasury's answer to this is that this committee need have no concern. Eliminate the partial liquidation sections, eliminate 311(d)(2)(B) and we will take care of the problem under the spinoff provisions. The mom and pop couple who have to split up, we will give them a 355 ruling, and they can spin off one of the businesses to the other party.

Let me tell you what really happens. You go in with a mom and pop business and you say they have got to split up, or the Smith brothers, we have come to a parting of the ways, we want to split up this business, and we think we have got two businesses. The Treasury has a list of reasons as long as 14 pounds of weiners why there are not two businesses. They will tell you it is all one business and you cannot have a spinoff.

Now what do you do? You know, it is easy to talk about spinoffs, but it is hard in the implementation.

Let's take the hotel that has a gaming establishment, so it is in two businesses. The State passes a law and says that a gaming establishment cannot be owned—the license must be held by individuals, so you have got to get rid of it. Now you cannot use a spinoff because it would still be in corporate form. You have got to use a partial liquidation.

Or take the kind of case that I am familiar with: a company that is worried about being taken over—the company this committee is trying to protect. It is engaged in one business. One part of its business generates cash. Another part has appreciated property.

The solution is to have a partial liquidation. We cannot get a spinoff ruling under 355. We can get a partial liquidation ruling now.

Now, this problem is not solved by 355. It is solved by the partial liquidation sections. And why should this company be penalized—it is trying to avoid being taken over. This bill is supposed to help it, and the effect of the bill is to deprive it of the only means it has for avoiding the peril it faces.

And I suggest to you that Nolan and Alexander and Camp and hopefully myself are correct. The amendment I suggest—and I have it written down here, is only about 10 words long:

> Where more than 50 percent of the stock redeemed has been owned for less than two years, the benefits of the partial liquidation sections and the benefits of Section 311(c)(2)(B) shall be denied.

And that is sort of a west coast lawyer's way of stating it; but that is the substance of it. Old and cold stock is protected, and that solves your problem of the publicized cases; and the revenue loss would not pay your aspirin bill—people do not go into partial liquidations because they want to. They go into them because they have to, there is some State statute or some problem that has come up. So you are not going to lose a lot of revenue.

The big dollars, as Senator Metzenbaum pointed out, $400 million in the United States Steel case, $150 million in the Richfield case, $250 million Esmark, that is about what they (the staff estimation) are talking about in revenue, and we are just not talking about that kind of money.

[The prepared statement of Hart H. Spiegel follows:]

STATEMENT OF HART H. SPIEGEL

THE MERGERS AND ACQUISITIONS BILL (S.2687)
SENATE FINANCE COMMITTEE OF THE UNITED STATES SENATE

July 15, 1982

My name is Hart H. Spiegel. I am a partner in the law firm of Brobeck, Phleger & Harrison, in San Francisco, and I have been actively engaged in the practice of tax law for 35 years. I served as Chief Counsel for the Internal Revenue Service from 1959 to 1961. I believe I have some appreciation of the need for periodic tightening or modification of the tax law; but I would urge that the committee not enact "quicky" legislation aimed at particular problems but having side effects which catch up innocent parties in the net.

Specifically, I direct the committee's attention to what I believe are some unintended and extremely damaging consequences of the sweeping provisions in the bill which effectively preclude partial liquidations.

The purpose of these provisions is to preclude the use of a partial liquidation as a vehicle for the acquisition of a portion of the assets or business of the target corporation; but the effect of the bill is to preclude the use of partial liquidations even where not used in a takeover situation. Let me explain. Under present law, if an acquiring corporation purchases assets of the target company, a tax is imposed on the selling company at the corporate level; and a second tax is imposed on the shareholders of the target corporation when they receive the proceeds. However, an acquiring corporation can, instead of buying assets, buy a portion of the stock of the target company and by arranging for a partial liquidation of the target company receive assets which it desires in exchange for its stock. The only tax cost is the capital gain tax on the selling shareholders. There is no tax at the corporate level.

This bill is directed at such takeover situations, where a purchase of stock followed by a partial liquidation is used as a substitute for a purchase of assets. The bill is designed to impose a tax at the corporate level on a partial liquidation preceded by a sale of stock, thus assuring that two taxes rather than one tax will be collected in such a takeover situation; just as if a purchase of assets had been effected. In short, the anti-partial liquidation provisions are designed to discourage if not preclude partial liquidations which are part of a takeover program.

There can be no dispute that this is the purpose of the legislation. When Senator Danforth introduced the bill, he said, and I quote

> "Mr. President, I am introducing a bill today which is designed to insure that corporations in taking over other corporations may not enjoy extraordinary tax benefits as a result of takeovers." (emphasis added) (Cong. Record June 29, 1982, S.7589)

Congressman Stark, who has introduced an identical bill (H.R. 6295) entitled The Corporate Takeover Tax Act of 1982 is similarly quoted in The Alameda Times Star for July 8, 1982. Congressman Stark said,

> "This legislation is premised on the idea that corporate takeovers should occur only when there is a real economic advantage to the deal..." (emphasis added)

The problem I have with these anti-partial liquidation provisions is that while their purpose is to dissuade takeover companies from acquiring the assets or business of a target company, one of their effects is to exact punitive taxes from small or medium sized corporations which have not acquired the stock of or merged with any other corporation, have no intention to do so and may, in fact, be trying to protect themselves from being swallowed up by corporate giants.

As I have stated, while this legislation is intended to apply only where it is the second step in a takeover program (the first being the acquisition of stock in the partially liquidated corporation), it in fact applies even though there has been no prior acquisition of stock; even though the partially liquidated corporation has not acquired the stock of any other corporation nor has its own stock been acquired by anyone.

The question arises, should an ordinary partial liquidation be outlawed when it is effected in the ordinary course of events, by a corporation, the stock of which has not changed hands and which is involved in no way with a takeover situation. It seems to me this was not the intent of the proponents of the legislation; and rightly so. These partial liquidation provisions serve a very useful and non-tax avoidance purpose. They have been in the law in their present form for at least 28 years. They have been used by hundreds of small and medium sized corporations to terminate one of their businesses or contract their business and distribute the unneeded assets to their shareholders with the shareholders paying a capital gain tax on the gain realized.

Take the company which is engaged in the soft drink business and also finds itself in the pesticide business. The two are not compatible from a marketing standpoint. The partial liquidation provisions permit the company to distribute the pesticide business to its shareholders where it may be run independently of the beverage business. Why should a tax be imposed on the corporation when it receives nothing and merely contracts in size by distributing a business to its shareholders. Or take a small airline which finds itself with a travel agency that it is forbidden to run in conjunction with the airline. The travel agency business can be distributed to the shareholders without the corporation incurring a tax. And why should it incur a tax simply because it is forced out of a business. Or take the utility which is forbidden by regulatory authorities from having any other business and must dispose of an unrelated business to its shareholders. Or take the case, which is occuring with ever increasing frequency and which epitomizes the unintended consequences of this bill, namely, a corporation which finds itself being eyed as a target company because of some division or business which generates large amounts of cash. That company can get out of the cash generating business by distributing it to its shareholders in partial liquidation, thereby warding off the attentions of the takeover corporations. A company which I represent, for example, has for nearly 100 years been in the agricultural, farming and commercial real estate business. It now wishes to terminate part of its business operations and distribute the proceeds to its shareholders, one significant purpose being to make the corporation less attractive to takeover corporations. This bill *effectively precludes* such a partial liquidation, thereby leaving my client impotent to protect itself from the very evil at which these bills are said to be aimed.

I am not testifying in defense of any corporate giants or in support of any takeovers. In general, I think these takeover situations in most cases leave much to be desired. But I respectfully suggest that a bill which is aimed at such takeover situations *should not apply where* there has not been a takeover of any kind whatsoever. In the reading I have been able to do on this legislation, there has been little, if any, suggestion that partial liquidations are bad *per se*; or that as a matter of fundamental tax policy, a corporation as well as its shareholders should be taxed when it terminates a business and distributes the assets to its shareholders. The theory behind this proposed legislation is that partial liquidations should not be permitted where they are part of a takeover arrangement or have been preceded by an acquisition of stock and the acquiring corporation is in reality purchasing assets; and a purchase of assets would normally give rise to a tax at the corporate level. But the *effect* of the bill is to forbid partial liquidations even when there has been no transfer of stock or no takeover arrangement, and where the transaction is not the equivalent of a sale of assets to an acquiring corporation.

The American Law Institute has for several years been studying the merger and reorganization sections of the Internal Revenue Code and has produced monographs as thick as your arm presenting the pros and cons and problems of various approaches. On a subject such as that, I strongly urge that the Senate not enact some "quicky" legislation aimed at one aspect of the problem but having side effects which spread throughout Subchapter C and catch up innocent parties and transactions in the net.

If, however, this committee feels constrained to enact legislation in this area, I commend for its consideration the minimal amendments outlined in the attached Appendix A, which would implement the purpose of the bill to preclude partial liquidations effected as part of a takeover program but would permit such partial liquidations effected independently of any takeover stock acquisition program and carried out for legitimate business reasons germane to the partially liquidated corporation and its shareholders.

The suggested amendments would, I believe, not result in significant revenue losses for the big dollars are in the U.S. Steel-Marathon Oil takeover situations which I surmise account for the bulk of the projected $700,000,000-$800,000,000 anticipated revenue.

I fully appreciate the fact that this bill covers subjects other than that which I have addressed, including takeover situations where the takeover corporation, desiring to buy a subsidiary of the target company, first acquires stock of the target company (usually by a tender offer) and then relies on section 311(d)(2)(B) to obtain the stock of the subsidiary by a distribution from the target company. The tax cost of this arrangement is a single tax on the purchase of the target company's stock, whereas if the subsidiary's stock had been purchased directly and the proceeds then distributed to the target company shareholders, two taxes would have been collected.

But here again, whatever evil may be seen, lies in the fact that section 311(d)(2)(B) is being availed of in connection with a stock acquisition. If this be bad, then I respectfully suggest that the bill should strike at the takeover arrangement; that the committee tailor its legislation to the scope of the problem.

I have read the statement of John S. Nolan appearing as Chairman of the Section of Taxation of the American Bar Association. I have been a member of that section for 25 years and have served on its council. I am confident the statement represents the views of the more than 25,000 lawyers who have in the past and continue to spend time on these matters.

APPENDIX A

MEMORANDUM

Re: Proposed Revisions to S. 2687

The primary purpose of S. 2687, introduced by Senator Danforth (and the corresponding bill, H.R. 6295, introduced by Representative Fortney Stark), is the closing of a perceived "loophole" involving the acquisition of one corporation's stock by a second corporation bent on acquiring certain assets of the first corporation. Under current law, a partial liquidation can then be undertaken to transfer the desired assets to the acquiring corporation in redemption of its stock. A partial liquidation results in no tax (other than a tax on recapture income) to the distributing corporation. If the distribution is made to a corporation owning at least 80% of the distributing corporation's stock, the tax on recapture income can be deferred indefinitely under the consolidated return regulations. The only other tax cost of such a transaction is a capital gains tax to the shareholders who sell their stock to the acquiring corporation.

In contrast, if the desired assets were sold directly by the distributing corporation to the acquirer, a corporate tax would be imposed on the realized gain; and a distribution of the after-tax proceeds would result in an additional capital gains tax to the shareholders.

The rule of nonrecognition to the distributing corporation in a partial liquidation results from an application of Section 336. This rule reflects the long-standing tax principle that, as a general rule, a corporation does not recognize income upon a distribution of appreciated property to its shareholders. See General Utilities & Operating Company v. Helvering, 296 U.S. 200 (1935). A complete reversal of this principle should not be undertaken to solve a problem which could be addressed by more limited legislation.

Most partial liquidations do not involve non-pro rata distributions to shareholders who acquired their stock to obtain ownership of the distributing corporation's assets. Instead, the run-of-the-mill partial liquidation involves a pro rata distribution of assets out of corporate solution to long-standing shareholders, who thereafter operate the properties in non-corporate form. This type of partial liquidation is not undertaken to avoid a tax at the corporate level upon a sale of assets and, therefore, should not be affected by the bill. Nevertheless, the bill as presently drafted would, with respect to such a transaction, trigger a tax at the corporate level on the appreciation inherent in the distributed assets. While there is arguably justification for imposing a tax on a sale of assets "disguised" as a redemption or a partial liquidation, the bill should not interfere with partial liquidations not involving a sale of assets.

We would suggest that the bill be tabled at the present time, pending a more thorough and reasoned analysis of this complex area of the tax law. We would further suggest that, if the bill is not tabled, it should be amended so as to restore the reference to "partial liquidations" in Section 336, and limit corporate non-recognition treatment to transactions which are not undertaken as disguised asset sales. This could be accomplished by providing, as Section 336(c), an additional exception to corporate non-recognition treatment, to wit:

> (c)(1) Subsection (a) shall not apply in the case of a partial liquidation if more than 50 percent of the stock of the distributing corporation redeemed in the liquidation was acquired by purchase by five or fewer persons within the two-year period ending on the date of the distribution.
>
> (2) Section 318(a) shall apply in determining the ownership of stock for purposes of this subsection. In applying section 318(a) for purposes of this subsection, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

The bill would also be amended so that Sections 331 and 346 of the Code would remain intact, thus affording shareholders of distributing corporations capital gain treatment upon partial liquidations, as presently defined.

This provision would apply to trigger corporate recognition in any situation where stock is acquired for the purposes of obtaining assets by means of a partial liquidation. The fifty percent requirement would virtually assure that corporate recognition could not be avoided by a distribution to a mixture of long-standing shareholders and recently acquiring shareholders. The rule taking into account the purchases by five shareholders would preclude avoidance through acquisitions by several purchasers. More elaborate safeguards could be provided, if deemed necessary.

The foregoing provision represents only one method of properly narrowing the bill. This or similar language should be incorporated into the bill so that it deals with the major problems being addressed, without doing violence to the basic non-recognition principle of Section 336.

HART H. SPIEGEL
GRADY M. BOLDING
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July 12, 1982

Senator DANFORTH. All right. Thank you, sir.
Mr. Dunn.

STATEMENT OF H. STEWART DUNN, JR., ESQ., IVINS, PHILLIPS & BARKER, WASHINGTON, D.C.

Mr. DUNN. Senator, my name is H. Stewart Dunn. I am a member of the law firm of Ivins, Phillips & Barker of Washington, D.C.

Unlike the other speakers, who have addressed the subject of the legislation in its overall aspects, since that has been rather well covered, I would like to focus on the effective date features.

We represent parties who have undertaken transactions well in advance of any notice of this and now find that those transactions to which they have committed themselves are substantially altered by proposed rules with an effective date of August 31, 1982, not only for acquisition but distribution.

There was no awareness by the best-informed scurces of any problem in this area that we are now discussing prior to May 6 of this year when Mr. Stark introduced his bill which I will call Stark I. Hearings were held on that on May 24 at which the Treasury, as Mr. Nolan pointed out this morning, raised a number of problems and objections to that bill and in fact which every witness expressed concerns and problems.

There was no reason to believe that that was to become the law in a short time.

The next development was when you yourself introduced your bill, 2687, and Mr. Stark introduced his revised bill, Stark II, on June 28. Those bills were not even available until after action was taken by this committee on July 1 and July 2. To this date, at least as of this morning, copies of the bill that we are discussing are not available and the effective date provisions are not available. However, as of yesterday afternoon the committee report was available, and there is an inconsistency between the effective dates as described in the committee reports and what have been described in the press releases.

Thus, we have a situation where it is, in fact, very difficult for anyone to know even what the effective dates are, but it is reasonably clear that they focus on the date of August 31, 1982 with a possible exception for binding contracts or outstanding tender offers.

On Monday, July 12, Mr. Stark held a hearing of his committee and reported out Stark III. In that, which is quite similar to the bill that we are discussing this morning, there is a further modification in the effective date provisions to exclude those who have requests for rulings filed as of July 12.

Now, what I propose to you, Senator, is that there is a need here to address this so that you do not cover persons, who have taken action in reliance of existing law, on matters on which one could have gotten a ruling at that time, at least prior to May 6, 1982. In the case of our clients, they made public announcements of their intentions to have gone out to make the acquisitions, which they had announced prior to May 6, the earliest of these dates, much less July 12; and a public announcement of intentions ought to be every bit as effective as submitting a request for ruling. We also have situations in which the parties have entered into letters of understanding; but these are not binding contracts, so we do not come within what appears to be the existing effective date rule.

I do feel that the changes that are being proposed were unexpected. As you say, this is an area in which there are many knowledgeable people, that is true, but all the knowledgeable people felt that this is what one could do, and in fact, the service was and is to this day issuing favorable rulings on those transactions.

I urge on you and on your staffs to recognize that there is a need to modify the effective date provisions. Like others, I suggest December 31, 1982; alternatively, as I say, where one has had a public notice of intentions to go through the transaction before May 6, 1982, this should be an exception to the general effective date rule.

[The prepared statement of H. Stewart Dunn, Jr., follows:]

Statement of
H. Stewart Dunn, Jr.
Before the
Senate Committee on Finance
On the Merger and Acquisition Provisions of H. R. 4961 and on S. 2687

July 15, 1982

My name is H. Stewart Dunn, Jr., of the law firm of Ivins, Phillips & Barker. My entire professional career of 25 years has been devoted to federal tax law, and I have been particularly interested over this entire period in Subchapter C of the Internal Revenue Code relating to liquidations, distributions, and reorganizations of corporations. I appear today on behalf of certain clients of our firm who undertook programs for the acquisition and/or liquidation of companies prior to the introduction of any of the recent bills on these subjects. Consequently, while I share the views expressed by the Tax Section of the American Bar Association and certain other witnesses today on the need for further study of these complex subjects, I will generally limit my brief comments to the effective date provisions of these proposals.

Before May 6, 1982, which was little more than two months ago, there was no notice from Congress, the Treasury Department, the Internal Revenue Service, or any other authoritative source that the long established rules governing partial and complete liquidations would be changed. In this important area of the law where certainty has always been a very important factor, the Reorganization Branch of the Corporate Tax Division, Office of Assistant Commissioner (Technical), has played the key role in interpreting and enforcing these provisions of Subchapter C. As of May 5, 1982, and perhaps even more significantly up to the present time, the Reorganization Branch has continued to accept and issue rulings on most of the very principles that are now proposed to be dramatically altered. The first notice of any proposed changes in these long established rules was the introduction on May 6 by Mr. Stark of H.R. 6295, which I will call Stark I. This was followed by a hearing before the Select Revenue Measures Subcommittee of the Ways and Means Committee on May 24.

At this hearing the consensus of the testimony, including that from the Treasury Department, was that while Stark I raised and addressed issues of importance, it was overly broad and did not produce the best legislative solution. It was also the consensus of the witnesses at that hearing that these subjects needed more detailed study. Consequently, it was assumed in the business community that, if this proposal were advanced at all, there would be substantial modifications and the public would have ample opportunity to comment on revised proposals.

Contrary to these reasonable expectations, on June 28 Mr. Stark introduced H.R. 6725 (Stark II), and Senator Danforth introduced an identical bill as S. 2687. The introduction of these bills received little publicity, and most knowledgeable persons in this area were not even aware of the existence of Stark II until after July 2 when these proposals were incorporated in the Senate Finance bill adopted out on that date. The language of this bill was reported out as Section ____ of H.R. 4961 on July 12, and was not available until yesterday.

While I share the thoughtful comments that this Committee has received this morning from other witnesses about the advantage of giving this matter further study before acting in such a broad and important area, I recognize that this Committee may decide to move ahead now with this legislation, and, therefore, I want to focus my remaining comments on the effective date provisions.

Title I of Stark II is applicable to distributions after August 31, and the provisions of Title II apply to acquisitions after that date. In my judgment, this is enormously unfair because it would change long established rules with no prior notice for persons who have commenced bona fide transactions before May 6, 1982, which is the first date on which there was any form of notification relating to these proposals. In obvious recognition of this inequity, H.R. 4961 creates two exceptions to the August 31, 1982 effective date for acquisitions pursuant to a binding contract entered into on or before July 1, 1982, and for tender offers that were outstanding as of that date. In a further effort to ameliorate the harsh effective date rule of Stark II, three days ago the Subcommittee on Select Revenue Measures of the Ways and Means Committee reported out Stark III, which has other exceptions to the August 31, 1982 effective date, including an exception if a request for ruling was on file with the Internal Revenue Service as of July 12.

I believe that a mere statement of the scope of the changes and of the various proposed effective dates is itself a compelling reason for changing the effective date provisions so that this new legislation will not apply to any transaction that was initiated in good faith prior to May 6, 1982. If a taxpayer can demonstrate by some objective standard the existence of a plan of acquisition and/or liquidation prior to May 6, 1982, then that taxpayer should be entitled to have the rules of existing law govern such acquisition and any subsequent liquidation. It appears that this reasoning is the basis for excepting from the scope of Stark III proposals in which a ruling request had been submitted prior to July 12. However, there are other more valid objective standards for determining the bona fide existence of a plan. I particularly refer to transactions in which the parties have given public notice to the business community of their intention to buy and sell stock or to make a tender offer to purchase stock. Another objective standard of proof would be where there is, prior to May 6, 1982, a signed letter of understanding between the acquiring and acquired corporation.

The goals of this Committee in adopting Section ____ of H.R. 4961 are long range goals to reform certain key provisions of Subchapter C of the Internal Revenue Code. While there is merit in these long range goals, it would be extremely unfair and counterproductive to seek to apply such major changes to transactions that were undertaken in good faith and with public notice prior to the earliest notice of the law. While I have suggested some specific proposals that would address these transition rules, of course, another reasonable resolution would be simply to extend the general effective date for several months to a date no earlier than December 31, 1982. I have attached to my written statement a summary of the effective date provisions of several significant changes in Subchapter C of the 1954 Code, and in each such precedent the effective date provisions have been structured so as not to alter the results to taxpayers who had initiated transactions in reliance of prior law. There is neither a policy goal nor a revenue need which supports changing long established rules to the detriment of taxpayers who have reasonably relied upon them in good faith in undertaking major acquisitions that were initiated prior to any notice of these changes.

In closing I would like to repeat a wise and apocalyptic story that I heard this week from a gentleman who is perhaps the most pre-eminent of all American tax lawyers. This person, who has devoted many decades in tax law as an academician private practioner, and held prominent government positions, was recalling that Congress was prepared to tax the income from state exempt bonds in 1942 provided the Treasury agreed this provision would be prospective only so that it would not apply to bonds issued before 1942. The Treasury declined, and political objections killed the provision. Exactly forty years later, this Committee is making modest efforts in this direction, but in this case has expressly adopted the wisdom that was rejected in 1942. I believe that you will find that a fair and reasonable effective date with respect to the acquisition and liquidation provisions will not only make these broad new provisions more equitable, but it will also dispel much of the concerns and objections that you are hearing today.

APPENDIX

To

Statement of

H. Stewart Dunn, Jr.

on H.R. 4961 and on S. 2687

July 15, 1982

Congress' past willingness to provide extended transition periods in the case of significant changes in Subchapter C adverse to taxpayers is illustrated by some of the transition provisions associated with five of the more significant adverse changes in Subchapter C since the adoption of the 1954 Code. These five changes are the 1966 amendment to § 351 dealing with transfers to investment companies, the 1969 revisions to § 305, the 1969 adoption of § 311(d), the 1969 adoption of what is now § 312(k), and the 1976 amendments to § 382 and § 383.

On November 13, 1966, Congress enacted Pub. L. No. 89-809. Section 203(a) of this act amended § 351(a) to provide that § 351(a) applied to transfers to an investment company only in the case of transfers made on or before June 30, 1967. The cutoff date here was more than seven months after the date of enactment of the legislation. Section 203(b) of the act added a new § 351(d) providing that, for investment companies in connection with which a registration statement was required to be filed with the

Securities and Exchange Commission, the June 30, 1967 cutoff would be considered complied with only if the registration statement had been filed by January 1, 1967. The time period between this date and the date of enactment is less ample, but even here the period is over a month and a half.

On December 30, 1969, Congress enacted Pub. L. No. 91-172, the Tax Reform Act of 1969. Section 421 of the act substantially revised § 305 of the Code, relating to distributions of stock by a corporation to shareholders with respect to the corporation's stock. Section 305 as revised was generally effective for distributions made after January 10, 1969, although in some cases the revisions were effective for distributions made after April 22, 1969. If certain conditions were met, however, two of the revisions in § 305 were made inapplicable to distributions of stock made before January 1, 1991. One of the changes to which this extended transition provision applied was § 305(b)(2), which provided that a distribution of stock was taxable if it, or a series of distributions of which it was one, had the effect of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. The extended transition provision applied to § 305(b)(2) if the stock with respect to which the distribution was made was outstanding on January 10, 1969, or was additional stock of that class of the corporation's stock having the largest aggregate fair market value on January 10, 1969. A further condition for application of the extended transition provision was that the stock with respect to which there was a receipt of property must have been outstanding on January 10, 1969, and that if both types of stock were outstanding on January 10, 1968, there must have been a distribution of property with respect to one class and a distribution of stock with respect to the other class on or before January 10, 1969. The reason for these requirements is explained as follows in Senate Report 91-552: "The transitional rule . . . was intended to apply only where the corporation's dividend policy and capital structure on January 10, 1969, were such that stock dividends paid by it would be taxable under the bill." The second provision of § 305 to which the extended transition provisions applied was § 305(b)(4), which provides that generally distributions of stock with respect to preferred stock will be taxable. Section 305(b)(4) does not apply to distributions of stock with respect to preferred stock made before January 1, 1991, provided the terms relating to the issuance of the preferred stock were in effect on January 10, 1969. These 21 year grace periods under § 305 illustrate the fashion in which Congress has been prepared to accommodate existing arrangements and expectations when it makes adverse changes in Subchapter C.

Section 905 of the Tax Reform Act of 1969 enacted § 311(d) of the Code, which provided that, with certain exceptions, if a corporation distributes appreciated property to redeem stock, the corporation is taxed on gain equal to the amount of the appreciation. This provision was effective generally for distributions after November 30, 1969. Section 311(d)(2)(C) provided, however, that the general rule of § 311(d)(1) would not apply to distributions before December 1, 1974, of stock of a corporation substantially all of the assets of which the distributing corporation held on November 30, 1969, if such assets constituted a trade or business actively conducted throughout the one-year period ending on the date of the distribution. This five-year transition provision of fairly general applicability again illustrates the willingness Congress has shown in the past to accommodate existing expectations when making changes adverse to taxpayers in Subchapter C.

Section 442 of the Tax Reform Act of 1969 added § 312(m) to the Code (now § 312(k)) providing that in computing the earnings and profits of a corporation, depreciation must be deducted on a straight-line basis. This amendment applied, however, only to taxable years beginning after June 30, 1972. Thus, the effective date was delayed more than two and one-half years beyond the date of enactment.

On October 4, 1976, Congress enacted Pub. L. No. 94-455, the Tax Reform Act of 1976. Section 806(e) of this

On October 4, 1976, Congress enacted Pub. L. No. 94-455, the Tax Reform Act of 1976. Section 806(e) of this act amended § 382 of the Code, and § 806(f)(2) of the act amended § 383 of the Code. The amendments imposed new limitations on the ability of a corporation to carry over net operating losses and other tax attributes when the ownership of the corporation changes. Pub. L. No. 94-455 provided that the amendments made to § 382(a), and the corresponding amendments to § 383, would be effective only for taxable years beginning after June 30, 1978, and that, in measuring the change in ownership from prior years, January 1, 1978, would be the earliest date as of which ownership would be considered. Pub. L. No. 94-455 provided that the amendments made to § 382(b), and the corresponding amendments to § 383, applied to reorganizations pursuant to a plan of reorganization adopted by one or more of the parties thereto on or after January 1, 1978. These effective dates have subsequently been changed several times, most recently to 1984, and these postponements have related to substantive reconsideration of the amendments. However, the original effective dates were more than a year later than the date of enactment, and therefore provided taxpayers with a significant amount of time to complete pending transactions before the amendments were scheduled to take effect.

Senator **Danforth**. Gentlemen, thank you very much for your testimony.

I would like now Mr. Yeeses of the Treasury, if you would, sir, to respond to the evidence we have heard.

What do we do to take care of the concerns, Mr. Yeeses, that have been expressed?

Mr. **Yeeses**. Senator, I have listened very carefully to the testimony today. I have not had an opportunity to read all of the written statements yet, but please be assured that we will study these carefully.

As Mr. Glickman testified, we believe that, and we readily acknowledge that the bills go beyond the case that you described; that is, the purchase of stock followed by the redemption. We do cover—the bills do cover liquidations and redemptions to historic shareholders although, as Mr. Glickman testified, we believe that still to be the right answer. That is that we believe, as the committee acknowledged in 1969 when it enacted section 311(d)(1), that economically there is little difference, if any, between a sale to third parties followed by a distribution of the proceeds, which is fully taxable to the corporation, and a straight distribution to the shareholders themselves in redemption of stock.

We are concerned that making exceptions to the exceptions, as the distinguished panels have suggested, will only lead to making further exceptions to those exceptions themselves. We think that the recent abusive cases have illustrated the problems with the defect in the statute, and that we think that to be at this time the appropriate response.

I think that we will obviously, as I mentioned, read the statements, and we will be more than happy to, as discussed with the other staffs, where the problems involved with the members of the panel, I think this is a healthy process in the development of tax legislation, but I think at this point I do not think the Treasury would necessarily subscribe, as we said in our testimony, to putting a bandage on the cut as the former Commissioner——

Senator **Danforth**. I mean, there is the difference between historic shareholders and acquisition.

Mr. **Yeeses**. As Professor Ginsburg testified, how are you going to define a historic shareholder? You lead to the problem of rewarding, as he mentioned, the patiently deviant.

There is a definition that was proffered, a 2-year period. Well, perhaps the acquisition can be spread out over longer than a 2-year period.

Whatever line you draw, I think that you are going to put substantial pressure on that line, and I question seriously whether it is necessary to draw that line.

Senator **Danforth**. Much of the testimony was aimed at the problem of catching mom and pop in the net.

Do you have any proposed answer to that?

Mr. **Yeeses**. Well, as Mr. Glickman testified, mom and pop can still do their division, their section 355 spinoff. To my mind, although I hesitate to disagree with the distinguished panel, it is hard for me to see why it is so much more complicated to distribute stock to shareholders than it is to effect the necessary asset transfers to shareholders. Maybe there are some cases in which transactions would not qualify under section 355, the 4-year active business, et cetera, but I do not know that this is necessarily a problem.

I think that we have a general rule in the tax law that a distribution of assets by a corporation, an ongoing corporation to shareholders which do not sufficiently reduce the shareholder's interest is taxed as a dividend. It is a little difficult, I think, for me to see and for Treasury to see why the result should not be the same merely because the business has been contracted in some way.

Similarly, in the partial liquidation as in the section 311 case, we cannot see why there is any difference between the case where the assets were sold, which would clearly generate a tax, and those where the assets are distributed directly.

If mom and pop need cash and they want to get their cash out of the corporation, ordinarily that is taxed as a dividend, and if the corporation sells the property to generate that cash, that is ordinarily taxed.

Senator **Danforth**. We have been told that there are cases when a partial liquidation is used as the technique for splitting up a company rather than a spinoff.

What about that situation?

Mr. **Yeeses**. Again, I think that many of those cases can continue to be covered by the spinoff and split-up. I think that we would want to discuss and study carefully those cases which cannot be, but those cases generally involve the withdrawal of assets from corporate solution. I question, Senator, why that is absolutely necessary.

Senator **Danforth**. Do you see any way to exempt the closely held corporation from this?

Mr. **Yeeses**. This is the problem that exists throughout the Internal Revenue Code, and to my knowledge, an adequate definition of closely held corporations does not, to my knowledge does not exist.

Also, closely held corporations may have millions and millions of dollars worth of operations. Closely held corporations are not always mom and pop activities.

Senator **Danforth**. Thank you very much, sir.

The next panel, we now have Gilbert Bloom, Early Brown, and Herbert Lerner.

Mr. Bloom?

STATEMENT OF GILBERT D. BLOOM, PARTNER, PEAT, MARWICK, MITCHELL & CO.

Mr **Bloom**. My name is Gilbert Bloom, a tax partner, a tax partner in the international accounting firm of Peat, Marwick, Mitchell & Co.

A number of situations have been brought to the attention of this committee and the House Ways and Means Select Revenue Subcommittee involving the use of redemptions and partial liquidations to avoid gain and recapture. These situations have stretched the intendment of the law to their ultimate limits. They have involved oil companies, they have received notoriety, and they have resulted in significant tax savings. This committee has proposed legislation against these transactions.

However, it is respectfully submitted that overlooked is the fact that 95-plus percent of all redemptions and partial liquidations are undertaken by small- and medium-sized corporations and are engaged in for cogent business purposes not involving takeover situations.

Publicly held corporations rarely if ever redeem stock or make distributions to their shareholders in partial liquidations. The cases that have made the newspaper are noteworthy only because they are aberrations.

The partial liquidation rules and the no gain or loss on redemption rules at the corporate level have generally been in existence in one form or another for over 50 years and have been relied upon by small companies to achieve legitimate business objectives without a huge tax penalty.

This act would invoke a corporate tax or convert capital gain to dividend income in a host of everyday, commonplace, nontakeover situations much to the detriment, and I might add, surprise of small business.

My remarks are limited to Title I of the act, and I have indicated in the written testimony a number of specific examples. I would like to take one of those specific examples and expound on that to indicate what I think the Senate is looking for as to specifics with respect to what this act does to ma and pa situations.

Assume a corporation owned by a father and two sons and two daughters, and it is closely held. They are engaged in the manufacture of paper products in the suburbs of a large city. It has been engaged in such activity for 10 years. In the heart of the city the corporation also runs a retail store that sells office supplies. It has done so for the past 4 years.

A fire, a storm, or water damage destroys the retail business in the city. Proceeds are received from insurance. The corporation decides that it is not appropriate to rebuild the business of the retail establishment and distributes the proceeds to the shareholders. Currently it would be taxed at capital gain. With this act it would be a dividend.

Assume, further, that the father may wish to be redeemed out. The corporation has little cash, does not desire to issue promissory notes because it would adversely affect its future borrowing power and it would not be appropriate to put it on the balance sheet. The corporation has vacant land which it wishes to distribute to the father. The father might retire, build a home on it, eventually subdivide the land and sell the plots to raise capital. Currently this would result in no tax at the corporate level. Now it would be a taxable transaction at the corporate level.

Assume that the same corporation wishes to disengage itself from the manufacturing business, sell all its assets. It is losing money, it does not have the appropriate funds to reinvest, it has found a good buyer, and it sells the manufacturing assets.

The distribution of the proceeds under existing law, pro rata, would be capital gain. Under this act it would be a dividend.

Assume further that the two sisters of these five shareholders do not get along with their brothers; there is acrimony. They wish to go their own way. It is desired to distribute the assets or the stock, I might add, of the retail store. Assets are put into a corporation and the stock is distributed, or the assets are distributed directly, whether or not the business is held for 4 years or 40 years at the shareholder level, we now have a tax at the corporate level; previously no tax.

Assume further maybe that this corporation would like to completely liquidate and operate the entire corporation in partnership form, but certain of valuable patents and licenses at the corporate level cannot be assigned, so all the assets pertaining to the manufacturing and retail business are distributed pro rate. The licenses and patents are retained by the corporation. This would result in dividend treatment at the shareholder level. Formerly it would have been capital gain.

Assume the father dies——

Senator **Danforth**. I am going to have to interrupt you, I am afraid, Mr. Bloom, because you have gone over your time.

Are these written, your examples?

Mr. **Bloom**. Yes.

Senator **Danforth**. They will all be included in the record.

Thank you very much.

[The prepared statement of Gilbert D. Bloom follows:]

Statement
of
Gilbert D. Bloom
on behalf of
Peat, Marwick, Mitchell & Co.
before the
Senate Finance Committee
regarding
The Corporate Takeover Tax Act (S. 2687)
July 15, 1982

My name is Gilbert D. Bloom, a partner in the National Tax Office of Peat, Marwick, Mitchell & Co., Washington, D.C. I appreciate the opportunity to present testimony on S. 2687 (The Corporate Takeover Tax Act) on behalf of the international accounting firm of Peat, Marwick, Mitchell & Co. While we anticipate that a number of clients might be affected by this Act, we have not been retained to present testimony on behalf of any client.

We are greatly concerned with the scope of this legislation and its deleterious impact on small and medium size corporations. The perceived abuses which generated this legislation can be cured in an easier and more simplified manner. It is not necessary to reverse almost 50 years of tax treatment to thwart relatively narrow situations. The Act would effectively reverse the 1935 Supreme Court case of General Utilities and Operating Co. v. Helvering, 296 U.S. 200 (1935), which was codified in 1954. Although Congress and the courts have developed a number of exceptions to nonrecognition treatment, the most significant of which was codified in 1969, tax free treatment has generally remained intact for a significant number of commercially desirable, business motivated, nontakeover situations. All this will change under the proposed Corporate Takeover Tax Act. The stated need for these new provisions is to prevent the corporate sale of assets via a redemption or partial liquidation. However, the proposed remedy to the perceived abuses will unfairly impact a multitude of nontakeover situations.

Title I would impose a new corporate level tax on non-pro rata distributions where appreciated property is distributed. No loss would be recognized at the corporate level. Title I would also convert capital gain to dividend income at the shareholder level where a pro rata distribution of assets or proceeds are received and the stringent five-year tests for two businesses are not maintained. Below are a number of "everyday" innocuous situations which would be adversely impacted by this legislation, either by: (1) the addition of a corporate tax, not presently provided for; or (2) the conversion of capital gain at the shareholder level to dividend treatment.

(1) Two businessmen transfer their business assets into a new corporation. Three years later, the parties decide that their corporate "marriage" does not work and they wish to "part company." The corporation distributes the assets, formerly contributed by one of the individuals, in complete redemption of that individual's stock interest.

(2) A corporation operates a ten-year manufacturing business and a four-year retail business of similar size. A fire destroys the retail business and the company decides to discontinue its retail operation. The proceeds are distributed pro rata.

(3) A small corporation is owned by a father and three children for 20 years. The father would like to retire from the business and have his stock redeemed. The corporation has insufficient cash to redeem father and an installment note is not desirable because such an obligation on the corporation's balance sheet would restrict future borrowings for business purposes. The corporation does have a number of parcels of vacant land not needed in the business but which could generate cash for the father in future years. The father is redeemed for the vacant land.

(4) A small savings and loan association is closely held. During the ten years of its existence, it has accumulated a number of foreclosed rental properties which are operated on a net lease basis. The savings and loan corporation has been losing money and all the shareholders would like to get out of the business. For liability purposes, it is appropriate to keep the real estate in the corporation. The corporation sells the savings and loan business and distributes the proceeds pro rata to the shareholders.

(5) Two brothers own all the stock of a corporation which is engaged in the production of wheat and corn. Both the wheat and corn operations have been actively conducted by the corporation for 25 years. For valid business reasons, the entire corn operation (acreage, machinery, inventory, and employees) is distributed to one brother in complete redemption of his stock in the distributing corporation.

(6) A high technology corporation engaged in business for eight years is owned equally by nine individuals. The corporation would like to completely liquidate, but due to the inability to assign valuable patents and license agreements, the corporation adopts a plan of "partial" liquidation and distributes all the assets other than the patents and licenses, pro rata.

(7) A corporation engaged in the active mining of nickel and iron, each for over 20 years, distributes all the assets of the nickel business to its shareholders, pro rata. Because of inadvertence or local law, the shareholders surrender back a proportionate part of their stock to the distributing corporation.

(8) A corporation operates the only newspaper and the leading television station in a small town. The newspaper has been owned for 50 years. The television station was acquired 4-1/2 years ago in a tax free merger where the sole shareholder of the target corporation received $3,000,000 of stock and $100 cash. A Federal agency has suggested that the lack of competition in the communication media in this town be resolved by the corporation distributing the television station assets (or stock of a new corporation holding the television station assets) pro rata to the shareholders.

These situations are not abusive, are not tax motivated, are not what this legislation is aimed at, but they would be greatly impacted by Title I, much to the detriment of a number of unsuspecting taxpayers. Thus, a few abusive transactions would be stopped but at a cost of placing a very heavy toll on the countless number of legitimate transactions which are not involved in "takeover" situations. Congress may not have received a substantial complaint about this legislation because, unlike other proposed legislation, there is no natural constituency for or against this bill. Its impact cuts across a broad spectrum of corporations and affects a corporation and its shareholders perhaps once in a corporate lifetime. It should not be assumed, however, that silence is acquiescence since a large number of small or medium sized corporations, in a multitude of endeavors, would be affected by this legislation. This is particularly troublesome since all the perceived abuses highlighted by this Committee and the House Ways and Means Select Revenue Measures Subcommittee could be corrected without jeopardizing the numerous nontakeover, nontax motivated transactions. Title I could be replaced with two changes to existing law. One, Congress can provide for the same recaptures on a partial liquidation (regardless of when the distribution is made) as are now provided for on a complete liquidation under section 334(b)(2). This similarity of treatment would take place even if a consolidated return were filed. Two, a corporate tax could be imposed on any non-pro rata distribution in redemption or partial liquidation where the recipient shareholder has not held common stock of the corporation for a fixed period of time (e.g., one or two years). With these changes in place, the main objectives of S. 2687 would be achieved.

Title II would replace section 334(b)(2) with new Code section 338 and provide for a deemed step-up in basis without an actual liquidation. This is an interesting concept. Existing law places a heavy premium on the correct corporation making the purchase of stock under section 334(b)(2). There are also many state laws, contractual, and business impediments which preclude an actual liquidation. Therefore, the concept of a deemed step-up in basis is desirable. However, this initial desirability is more than offset by an unduly complicated set of new rules. Section 338 is a web of intricacy designed to prevent "selectivity," i.e., buying assets and achieving a step-up in basis at the same time a related corporation's stock is purchased and that corporation is kept intact. Section 338 also seeks to end the ability of a recently purchased corporation remaining in existence for a considerable period of time prior to an actual liquidation.

The background material accompanying this legislation has made much of the evils of "selectivity." We are aware of no IRS revenue ruling, litigation, or newspaper accounts of situations which suggest a need for section 338 to cure the problem of selectivity. To illustrate the lack of a problem in this area, assume Mr. Jones owns a corporation engaged in the clothing business and Mr. Smith owns a corporation engaged in operating an apple orchard. Under both current law and this proposed legislation, purchasing corporation could purchase the stock of both corporations and decide to liquidate one and keep the other in existence. However, if Mr. Jones' clothing corporation owned a subsidiary engaged in the apple business and a corporate buyer purchased both corporations, new section 338 would mandate a "deemed" liquidation for both or none.

The rules of the new section 338 are unduly harsh. If farmer A operating as a corporation ("A") buys a lawn mower from unrelated corporation B (engaged in farming) and three years later (new section 338(g)(4)) corporation A buys the stock of corporation B, a deemed election will mandate recapture income even though A does not want to step-up in the basis of B's assets but would want the corporation to remain separate. We see no abuse here.

If a delayed liquidation is undesirable, Congress merely has to shorten the time period between purchase and liquidation. Moreover, a delayed liquidation is of no particular benefit to the taxpayer. Target corporation's losses cannot be offset against the purchasing corporation's profit due to the separate return limitation year ("SRLY") rules. Moreover, any delay in the section 334(b)(2) liquidation of the acquired corporation will in a number of situations have detrimental effects for the corporations by the loss of depreciation and resulting basis of assets; the former by the failure to depreciate at a higher figure, the latter by the hypothetical earnings and profits rules of the regulations under section 334(b)(2).

In summary, we believe that the proposed corrections are wholly disproportionate to the perceived abuses and this new legislation will unfairly impact a countless number of "legitimate" transactions. Notwithstanding the above, if this Committee wishes to legislate in this area, it is believed that the effective date for the elimination of the partial liquidations should be similar to the effective date for changes in complete liquidation. Namely, the effective date should be with respect to acquisitions made subsequent to August 31, 1982.

Senator DANFORTH. Mr. Brown?

STATEMENT OF EARL C. BROWN, TAX PARTNER, ARTHUR ANDERSEN & CO., WASHINGTON, D.C.

Mr. BROWN. Thank you, Senator.

My name is Earl Brown and I am a partner, head of the corporate reorganization tax specialty team, and head of the Chicago merger and acquisition program for Arthur Andersen & Co. We welcome the opportunity to testify before this committee on the subject of the proposed merger legislation.

Mr. Chairman, on May 24, 1982, I testified before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means of the House of Representatives. During that testimony I stated that we believe that contrary to the stated reasons behind H.R. 6295, most corporate acquisitions are not tax motivated. Rather, we believe that the chief impetus behind virtually every corporate acquisition is consistent with a desire to acquire the business and/or assets of the acquired company for sound economic reasons.

While much of the focus of the proposed legislation deals principally with taxable acquisitions, it should be noted that many acquisitions use techniques that do not provide for increases in tax bases. We have heard a lot of discussion this morning about some major transactions. A major one that did not provide for increased tax bases, yet still involved a great deal of cash was the acquisition by DuPont of Conoco. DuPont issued considerable cash and stock for the assets of Conoco in a merger transaction. Despite the significant tax liability incurred by the Conoco shareholders, it is our understanding that DuPont received no step-up in the tax basis of Conoco's assets. We could point to many other transactions in which this result also occurred. The point is simply that taxes are not the predominant motive behind many acquisitions.

Turning to the specific proposals that have been made in S. 2687 and related bills, we do think tax symmetry justifies that certain amendments should be made to the current tax rules regarding acquisitions. However, we believe that the proposed revisions are too far reaching and would have a very negative impact on corporate taxpayers in general and small businesses in particular.

In addition, the committee should be aware that any legislation that reduces the ability of a purchaser to recover its investment as quickly as before would obviously have an unfavorable impact on the value of a company when it is sold. A substantial number of changes of corporate ownership that involve small businesses are necessitated by estate tax and other justifiable economic reasons.

I would like to refer to a couple of specific solutions that I have to some of the provisions.

In regard to redemptions under 311(d)(2), I think that an increase in the holding period or making the provision applicable only to noncorporate shareholders would clearly solve any of the abuses that the committee has considered.

As to the partial liquidation provisions of the statute, I find that any abuses in the example given regarding a warehouse fire and the substantial contraction of a business can be solved by amending the consolidated regulations or providing for an immediate recapture of investment tax credit after a period of a year or so without preventing partial liquidations from being effective in many cases where they should be.

As to section 334(b)(2), I have two comments. The 75-day election period, could be very much a trap for the small businessman who may not be aware of the need to make that election within 75 days. I also submit that our experience has been that 75 days is not an adequate time period. We would urge the committee to consider a 180-day period.

The last comment I would like to make relates to the effective date provisions which have been discussed by other panelists. I would urge the committee to consider providing that the effective date applicable to acquisitions after some date in the future, either August 31 or perhaps December 31, provide that if a plan of liquidation is adopted within 2 years thereafter, or distributions in partial liquidation are made within 1 year of the acquisition, that present law apply.

Senator DANFORTH. I am sorry, I am going to have to interrupt.

Mr. BROWN. OK.

[The prepared statement of Earl C. Brown follows:]

ARTHUR ANDERSEN & CO.

TESTIMONY OF EARL C. BROWN

SUMMARY OF SIGNIFICANT POINTS

1. Contrary to the stated reasons behind H.R. 6295 and S.2687, most corporate acquisitions are not tax motivated. Rather, the chief impetus consists of a desire to acquire the business or assets of the target company.

2. While certain adjustments to the current rules are necessary to achieve tax symmetry, the proposed revisions are too far-reaching, and would have a negative impact on corporate taxpayers and small business. Therefore, the current bill should deal with only the specific perceived abuses in this area.

3. Our specific comments on the bills are as follows:

   A. The effective date of the bill should be amended to apply only to acquisitions commenced or plans of liquidation adopted after August 31, 1982.

   B. With respect to Section 311(d)(2) of the Code, the potential abuse can be corrected by taking either or both of the following two steps:

      a. Inserting at least a one year holding period requirement in each of these provisions (or lengthening the current holding period requirement).

      b. Providing that these provisions would only apply if the redeemed shareholder is a noncorporate shareholder.

   C. The contraction test of the partial liquidation provision should not be eliminated. Rather, the current problem can be cured by requiring the Treasury Department to amend the consolidated return regulations to provide for the recapture of investment tax credit in a partial liquidation. In addition, the Treasury should study whether tax deferral of depreciation and other forms of recapture is appropriate in a partial liquidation.

   D. The major problems of Section 334(b)(2) can be corrected by requiring the liquidation to occur within one year of the date of the stock purchase. However, if the bill is enacted as currently drafted, the time for making the election needs to be extended.

My name is Earl C. Brown, and I am a Partner, Head of the Corporate Reorganization Tax Specialty Team, and Head of the Chicago Merger and Acquisition Assistance Program for Arthur Andersen & Co. We welcome the opportunity to testify before this Committee today on the subject of the proposed "Corporate Takeover Tax Act".

Ours is an international accounting practice with offices in major parts of the world. While we have many clients who would be affected by the proposals that will be considered, we do not represent them in this testimony and the views expressed are those of the firm itself.

Mr. Chairman, on May 24, 1982, I testified before the Subcommittee on Select Revenue Measures, Committee on Ways and Means of the House of Representatives. During that testimony, I stated that we believe that, contrary to the stated reasons behind H.R. 6295, most corporate acquisitions are not tax motivated. Rather, we believe that the chief impetus behind virtually every corporate acquisition has consisted of a desire to acquire the business and/or assets of the acquired company for sound economic reason.

While the focus of the proposed legislation deals principally with taxable acquisitions, it should be noted that many acquisitions use techniques that do not provide increases in tax basis. An example of the more typical transaction was the recent acquisition of Conoco by DuPont Corporation. There, DuPont issued cash and its stock for the assets of Conoco in a merger transaction. Despite the significant tax liability incurred by the Conoco shareholders, it is our understanding that DuPont received no step-up in the tax basis of Conoco's assets. While we could point to many other transactions in which this result also occurred, the point is simply that taxes are not the predominant motive behind acquisitions.

Turning to the specific proposals that have been made in S.2687 and related bills, we think tax symmetry justifies that certain amendments should be made to the current tax rules regarding acquisitions. However, we believe that the proposed revisions are too far reaching, and would have a very negative impact on corporate taxpayers in general and small business in particular. In addition, the Committee should be aware that any legislation that reduces the ability of a purchaser to recover its investment as quickly as before will obviously have an unfavorable impact on the value of a company if and when it is sold. A substantial number of changes of corporate owndership that involve small businesses are necessitated by estate tax and other justifiable economic reasons.

It should be noted that the proposed revisions to Subchapter C of the Internal Revenue Code contained in these bills would reverse law, part of which has been in effect for 50 years. Therefore, given the shortness of time involved since these bills were proposed, we feel that the current bill should attempt to deal with only the specific perceived abuses in this area. If further changes are desired, they should come only after a complete review of Subchapter C. Our comments on the specific provisions in S. 2687 are as follows:

1. Effective date of the legislation. We believe that the bill should make it clear that the effective date of the legislation should be for acquisitions commenced on plans of liquidation adopted after August 31, 1982. Companies who have commenced transactions in reliance on current law should be afforded the opportunity to complete those transactions on that basis.

2. Proposed amendments to Section 311(d) dealing with redemptions using appreciated property. The objection to this provision is that it can be used to allow a corporation to, in effect, sell a business while avoiding tax at the corporate level on the sale. Typically, this would be done by having the acquiring corporation first purchase stock of the selling company, and then the acquiring company would exchange the purchased stock with the selling company in exchange for appreciated property. We believe that this is an area that needs to be corrected. However, it should not be done by eliminating Sections 311(d)(2)(A), (B) and (C). Rather, the potential abuse can be corrected by taking either or both of the following two steps:

   a. Inserting at least a one year holding period requirement in each of these provisions (or lengthening the current holding period requirement).

b. Stating that these provisions would apply only if the redeemed shareholder is a noncorporate shareholder.

If these changes are made, it will prevent the use of Section 311(d)(2) to achieve a tax free sale of appreciated property to another corporation. At the same time, it will allow the continued legitimate use of this provision in structuring the business affairs of closely-held companies.

3. Partial liquidations. The perceived abuse here is that if a partial liquidation occurs in a consolidated group of corporations after a stock purchase, the basis of the target company's assets can be increased, while investment credit recapture is avoided entirely and depreciation and other forms of recapture are deferred until the asset is depreciated. While an argument can be made that the deferral concept with respect to depreciation recapture is appropriate, since it provides for a better matching of income and deductions, no such argument can be made for the avoidance of investment tax credit recapture in this situation.

However, we question whether the appropriate means to deal with this type of situation is the complete elimination of the contraction test of the partial liquidation provisions. We believe that there are situations where the contraction test is an appropriate vehicle for capital gain treatment at the shareholder level, even though the distribution would not meet the five year active trade or business test of the partial liquidation provision. For example, suppose that a corporation operated a warehouse with seven stories. The top two stories of the building burned down. Thereafter, the warehouse only operated with five stories. In this situation, if the insurance proceeds were received and distributed to the shareholders, we believe that partial liquidation treatment would be appropriate for an individual shareholder of shareholders even though the distribution would not be attributable to the corporation's ceasing to conduct a business. This results since the distribution is attributable to a significant reduction in the corporation's level of business operations. Therefore, it would seem appropriate to grant the shareholder capital gain treatment, since this is not akin to an ordinary dividend distribution. See Joseph W. Imler, 11 T.C. 836 (1948) (Acq.), and Section 1.346-1(a)(2)(iii) of the Income Tax Regulations.

Here, we believe that the current problem can be cured by requiring the Treasury Department to amend the consolidated return regulations to provide for the recapture of investment tax credit in a partial liquidation. In addition, the Treasury should study whether tax deferral of depreciation and other forms of recapture is appropriate in a partial liquidation.

This would eliminate the current problem of the avoidance of ITC recapture in a partial liquidation, while preserving the legitimate use of the provision by closely held entities.

4. Elimination of Section 334(b)(2). We would first like to note that Section 201 of the bill would eliminate over 30 years of both court made and legislative law. We have not yet had an opportunity to analyze thoroughly the radical changes that this provision would make to the tax consequences of stock purchases. A more appropriate answer may be to amend Section 334(b)(2) to require that the liquidation be completed within one year after the stock of the target company is purchased.

In the alternative, if the provision is enacted as prescribed, we believe that, as a minimum, the time for making the election under Section 338 needs to be extended. Currently, S. 2687 provides that the election would have to be made "not later than 75 days after the acquisition date". The acquisition date is defined to mean the date on which the acquiring corporation first purchases the stock of the target corporation. In today's environment, many times the process of tendering for a target company's shares takes many weeks and months. Therefore, we believe that the time for making the election should be made by reference to the date on which the acquiring corporation acquires at least 80% of the target corporation stock by purchase.

In addition, we do not believe that a 75 day period is sufficient time to make the election. For example, in the case of a small business that makes a stock purchase, this type of provision could be overlooked inadvertently. In addition, even with respect to larger companies, it is typical to have an appraisal performed, prior to a liquidation to step-up a target company's assets to determine whether the liquidation is justified from a tax standpoint. The appraisal process and the detailed computations necessary for this analysis rarely can be performed in a 75 day period. Therefore, we would recommend that the 75 day period currently in the provision be extended to at least a 180 day period.

Mr. Chairman, I would like to thank you for the opportunity to testify on this matter. While we do not agree that most mergers and acquisitions are tax motivated, we agree there are some provisions in the current statute that should be changed. However, we believe that the statute as presently drafted is overreaching in its scope. Accordingly, if the changes noted above are made, it should correct the perceived problem areas, while allowing the continued use of these provisions in legitimate business transactions.

Senator **Danforth**. Thank you very much.

Mr. Lerner?

STATEMENT OF HERBERT J. LERNER, PARTNER, ERNST & WHINNEY, WASHINGTON, D.C.

Mr. **Lerner**. Thank you, Mr. Chairman.

My name is Herbert Lerner. I am a partner in charge of the Washington Tax Services Group of Ernst & Whinney. My comments today will be limited to the partial liquidation provisions and the section 334(b)(2) proposals, although we do have more covered in our complete statement.

Initially I would like to say I agree with the comments made by the American Bar Association representatives. I think that things have moved too fast in this area. There are a number of problems that I would like to just point out to you in the limited time that we have here.

As to the partial liquidation provisions, I think it is quite clear that those provisions have traditionally been used mostly by closely held small business corporations for making distributions under extraordinary circumstances, and we would agree with others that this proposal will create special hardships in those cases.

The example given of the fire is a fine, simple example. There is tax at the corporate level as well as tax at the shareholder level when the proceeds are distributed. The same thing would be true for a condemnation award for a portion of a farm conducted in corporate solution. There would be tax at the corporate level, and if the proceeds were not needed in the continued activity at the corporate level, the distribution to the shareholders under present law would be taxed at capital gains rates.

It is quite clear that under section 302(e) as proposed, that would be ordinary income, dividend income if distributed pro rata to the shareholders. We do not understand why that makes sound tax policy. If that is the intended result, we really, seriously question whether it has been thought through.

A very simple solution to the problem of distributions to individual stockholders we think would be to limit the change in section 346 treatment so that it would not apply to noncorporate stockholders; to be no change under 331(a)(2) and 346, so that there would be no addition of section 302(e) to the code. We see that as just adding a level of complexity and in effect producing this unfortunate result of dividend equivalents where there has already been tax paid at the corporate level, 346 has also been used as a technique for achieving selective step-up in acquisition transactions. There is no question that those transactions do give rise to the potential for abuse, but there is also no question that those transactions are entirely consistent with present law, have been ruled routinely by the Service as appropriate transactions, and are consistent with the consolidated return regulations.

For that reason, we think that the effective date ought to be keyed to stock acquisitions occurring after a future date. There is no question there are problems of companies that have effected acquisitions in the past that could not because of other constraints use the provisions of section 334(b)(2) and have used the partial liquidation as a technique to avoid a problem under present law. A genuine problem, for example, is present for a regulated company like a bank or a life insurance company that could not complete a liquidation into the purchaser of the stock. Transfer of that stock to another member, followed by a partial liquidation solves a combination of regulatory and tax problems. That can only be achieved, it seems to me, if your effective date provision is keyed to acquisitions occurring after a date rather than distributions occurring by August 31 as proposed.

With respect to the 334(b)(2) provisions, I would agree wholeheartedly with the desirability of having an election provision, if you are talking about a single corporation. If you are talking about a multitiered group, there is no question that will create more problems than I think anyone can envisage.

An illustration might be appropriate. If you have a lower tiered DISC, if you have either a sale of assets at the upper level or you have an election at the upper level, you have automatic requirements for elections throughout the group. You will trigger DISC income, bad debt reserves, insurance reserves, controlled foreign corporation earnings, previously agreed to deferred amounts under closing agreements, all of which really is inappropriate. That kind of broad brush solution to the problem I think has not been sufficiently thought through.

[The prepared statement of Herbert J. Lerner follows:]

STATEMENT OF ERNST & WHINNEY

ON THE

"CORPORATE TAKEOVER TAX ACT OF 1982"

BEFORE THE

SENATE FINANCE COMMITTEE

ON

JULY 15, 1982

Mr. Chairman and Members of the Committee:

My name is Herbert J. Lerner. I am the Partner in Charge of Washington Tax Services for the international accounting firm of Ernst & Whinney. I appreciate this opportunity to express our firm's views on the "Corporate Takeover Tax Act of 1982" (S. 2687), which is to be included as part of the Finance Committee's revenue-raising provisions for 1982.

Although I am a member of a firm which has advised clients as to transactions that may be affected by the provisions of this bill, our comments submitted today are those of the firm and do not represent comments made on behalf of specific clients.

General Comments

The Chairman is to be commended for holding these hearings to consider problems with respect to the provisions of S. 2687, even though the substance of the proposal has been approved by the Senate Finance Committee as part of the 1982 revenue-raising tax legislative program. The subject matter deals with highly complex areas of the Internal Revenue Code regarding the tax aspects of corporate acquisitions, partial liquidations, and redemptions. It is hoped that these hearings will provide useful information to the committee members on substantive issues which may not have been considered in connection with the proposed bill and may form a basis for appropriate modification of substantive provisions as well as equitable transitional rules.

Title I — Changes in Tax Treatment of Partial Liquidations and Certain Distributions of Appreciated Property.

Partial Liquidations

Current Law: Amounts distributed in partial liquidation of a corporation generally qualify for capital gains treatment to the exchanging shareholder. Under current law, a distribution qualifies as one in partial liquidation if the distribution: (1) is one of a series of distributions leading to a complete liquidation (§346(a)(1)); (2) is not essentially equivalent to a dividend and results in a genuine contraction of the corporation (§346(a)(2)); or (3) is attributable to the cessation of one five-year active trade or business and the distributor continues to conduct another five-year trade or business (§346(b)).

No gain or loss is recognized to the distributing corporation as a result of a partial liquidation, except for recapture tax items, such as prior depreciation, investment tax credits (ITC), and certain tax benefit amounts. Further, the fair market value of the distributed assets becomes the tax basis to the recipient shareholders, except where the distributor and the distributee are members of an affiliated group filing a consolidated return.

Under the present consolidated return regulations, the partial liquidation of one member does not give rise to immediate recognition of recapture income. Such recapture amounts are deferred and triggered into income as the stepped-up basis is recovered in the future. There is no recapture of ITC. Consequently, there is no additional ITC earned with respect to the assets received by the corporate distributee. Further, the acquiring corporation's basis for the assets it receives in the partial liquidation will be an allocable portion of its adjusted basis in the stock of the distributing corporation. This allocation will be based on a comparison of the respective fair market values of the assets distributed and those retained by the distributing corporation.

Proposed Changes: The partial liquidation provisions of §346(a)(2) (a corporate contraction) would be repealed. A distribution that is one of a series in redemption of all of a corporation's stock under §346(a)(1) would be reclassified as a complete liquidation. The so-called "safe-harbor" provisions of §346(b) would be retained in new §302(e) for non-corporate shareholders; such distributions would be treated as redemptions that are "not essentially equivalent to a dividend" at the shareholder level. In addition, §336 would be amended to provide that only distributions in complete liquidation would be tax-free to the distributing corporation.

Ernst & Whinney Comments: The current partial liquidation provisions were adopted in the 1954 Code to provide certainty of tax treatment for distributions of corporate assets which constitute a genuine contraction or which satisfy the requirements of §346(b). These provisions have traditionally been used by small businesses for making distributions under extraordinary circumstances.

We believe this proposal would create special hardships for these smaller, closely held businesses which would no longer have available the genuine contraction rules of present law. For example, if a fire destroyed a substantial part of a corporation's only business and the corporation wanted to distribute the insurance proceeds pro rata to its individual shareholders, such a distribution would not qualify for capital gains treatment since the standard of present §346(b) (or the proposed standard of §302(e)) would not be applicable. We question whether this is the intended result, and if so, whether it is sound tax policy. Perhaps a simpler and more equitable solution to the problem of limiting §346 treatment to noncorporate shareholders would be to have §331(a)(2) and §346 only apply to noncorporate shareholders, rather than add complexity to the Code by adopting new §302(e).

In recent years, §346 has also been used as an alternative acquisition technique to obtain a stepped-up basis for the assets of a target company received in a partial liquidation following a purchase of a target company's stock. This has been achieved without the detriment of immediate recapture liability by virtue of the consolidated return regulations. It has also been used as a technique for selective step-up of assets of the target company.

However, the additional use of §346 in acquisition transactions is clearly permitted by the consolidated return regulations and has also been the subject of routine approval by the IRS in private rulings on both the Subchapter C aspects of the transaction as well as the consolidated return rules.

In some instances, the §346 technique has been used to overcome practical problems of achieving a stepped-up basis for assets under §334(b)(2) because of the specific statutory constraints of that latter provision. For example, §334(b)(2) requires that control of the target company be achieved in a "purchase" transaction and that the distributee be the purchaser. In some instances, the "purchaser" may be a corporation which cannot operate the assets and business of the target company due to regulatory restrictions, e.g., in the case of banks and life insurance companies. If the initial stock acquisition is made by a nonqualified purchaser, the only way to achieve a stepped-up basis for the target assets is to transfer the target stock to a qualified distributee and then have a partial liquidating transaction. Section 334(b)(2) also requires that the purchase and liquidation be accomplished within certain set time periods which may not be met due to nontax reasons.

Although there may have been some abusive uses of the partial liquidation rules under current law, the fact that such broad use of §346 has been sanctioned by the IRS and is consistent with the current statutory provisions suggests that any curtailment of its application should not be done without due regard to stock acquisitions which have occurred prior to the proposed statutory changes.

Therefore, we urge that any such changes be prospectively keyed to stock acquisitions occurring after August 31, 1982, rather than the proposal for distributions occurring after that date. Because the announced purpose of the legislation is to deal with "takeovers", it should not alter the tax treatment available under current law for prior acquisitions (whenever made prior to September 1, 1982). If an effective date keyed to the acquisition of stock is not adopted, the effective date should, at a minimum, be keyed to plans of partial liquidation adopted after August 31, 1982. This would permit regulated businesses to adjust to the change on a reasonably timely basis. Either approach could be coupled with a fixed date for distributions which should be no sooner than December 31, 1982.

Distributions of Appreciated Property

Current Law: Some of the exceptions under which a corporation is permitted to distribute appreciated property in redemption of its stock without recognizing gain or loss under §311(d) are:

(a) Distributions in complete redemption of a 10 percent or more shareholder (§311(d)(2)(A));

(b) Distributions of stock or debt of certain subsidiaries (§311(d)(2)(B));

(c) Distributions of stock or securities made pursuant to an anti-trust decree (§311(d)(2)(C)); and

(d) Distributions made to effectuate the terms of the Bank Holding Company Act (§311(d)(2)(G)).

Proposed Changes: The proposed legislation would repeal the above listed exceptions to the recognition of gain under §311(d).

Ernst & Whinney Comments: The repeal of the enumerated exceptions is designed to eliminate a perceived abuse involving the acquisition of assets held by a corporation. For example, if a corporation's stock is purchased and it is subsequently redeemed for appreciated property held by the redeeming corporation, it will not recognize gain on the redemption if one of the exceptions to §311(d) applies. In such a transaction, the redeeming shareholder will obtain a step-up in the basis of the acquired asset whereas the other party to the transaction, the redeeming corporation, recognizes no gain or loss. Although the current Code provisions may result in abuse in certain situations, we feel that the proposed legislation may be too harsh a remedy. The exceptions to §311(d) were intended to deal with redemptions made for specific reasons. Repealing four exceptions to §311(d) would be inconsistent with the Congressional intent underlying the enactment of such provisions.

One manner in which the Internal Revenue Service could attack prearranged transactions involving the sale of stock followed by its redemption for appreciated property is under the step transaction doctrine. A second possibility would be to focus on the exception that permits distributions in complete redemption of a 10 percent or more shareholder and distributions of stock of a subsidiary. Rather than completely repeal these exceptions, they could be modified to extend the length of time that a shareholder must hold the stock before the corporation can redeem it and distribute property without recognizing gain or loss.

In summary, the need to curb the tax-free "sale" of corporate assets through corporate redemptions does not warrant eliminating provisions that have been developed to deal with legitimate commercial transactions. We do not believe that the proposed legislation is the most reasonable or rational approach to solving a problem that the Internal Revenue Service could most likely successfully challenge in the courts based on existing general tax principles.

Title II -- Election to Have Stock Purchase Treated as an Asset Purchase

Current Law: Under §334(b)(2), when one corporation purchases 80 percent or more of a second corporation during a 12-month period and the second corporation adopts a plan of liquidation within two years and thereafter completely liquidates, the transaction is treated in effect as a purchase of assets. The basis in the assets is stepped up (or down, as the case may be), and the liquidating corporation recognizes no gain (or loss) except for recapture on certain items.

Proposed Changes: Under the proposed legislation, §334(b)(2) would be repealed and replaced with new §338, which generally provides that the corporation purchasing stock of a target corporation may elect to step-up the basis of the assets of such corporation as if the latter corporation had sold all of its assets on the date 80 percent control is achieved. The target corporation would be treated as having sold its assets to a new subsidiary of the purchasing corporation in a transaction described in §337. The target corporation would then be treated as the new subsidiary of the acquiring corporation.

Ernst & Whinney Comments: The elimination of §334(b)(2) and creation of a §338 election is designed to eliminate the perceived inconsistent treatment under current law between a direct purchase of assets and a purchase of stock followed by a liquidation of the target corporation to obtain its assets. In the latter case, during the period of time from the purchase of the stock of the target corporation until its liquidation, the target corporation's tax attributes, such as loss and credit carry-forwards, may be available for use on the purchasing corporation's consolidated return. Furthermore, when it is liquidated, the target corporation's recapture income may be offset by losses of the purchasing corporation. However, if the assets of the target corporation are purchased directly, the purchasing corporation is unable to avail itself of the selling corporation's tax attributes, and recapture income taxed to the selling corporation cannot be offset by losses of the acquiring corporation.

The proposed legislation would eliminate this inconsistency by providing that the purchasing corporation could not obtain a step-up in the basis of the target's assets unless the acquiring corporation makes the election.

We agree in principle with the approach taken by the proposed legislation to provide symmetry between a deemed purchase of the assets of a corporation and an actual purchase of its assets. The inclusion of all corporate acquisitions under one uniform rule will provide a more rational tax system by eliminating the form over substance approach of current law. It will also eliminate undue complexity under §334(b)(2).

However, we also believe that this is a highly complex area and significant legislation, such as is proposed here, should not be enacted without further analysis and study. This is evidenced by some of the problems caused by the proposed legislation in its present form. For example, if a purchaser of a target corporation with lower-tier subsidiaries desires to make the election with respect to the purchased corporation, the election will automatically apply to all of the corporations in the affiliated group, with the result that all of the assets of the purchased corporation as well as its subsidiaries will receive a step-up in basis. The appropriate recapture provisions will also apply as if the assets of the subsidiaries had been sold pursuant to a §337 liquidation. Accordingly, if one of the lower-tier subsidiaries is a Domestic International Sales Corporation ("DISC") with recapturable income, this income would be triggered by the parent corporation's election, despite the fact the shareholder of the lower-tier DISC does not change.

Other situations involving similar results include lower-tier subsidiaries that have bad debt reserves; insurance reserves; holdings in controlled foreign corporations, the disposition of which could result in a §1248 pick-up; and §1248 closing agreements. Accordingly, the making of an election after a qualified purchase of the stock of a multi-tier, multi-national corporation could open "Pandora's box" with respect to the triggering of taxable income which may be inconsistent with other important tax policy considerations. Further, under these circumstances we question whether many purchasers would be in a position to make the election within 75 days after the date of acquisition. Moreover, this proposed legislation, deeming a sale to occur in lower-tier subsidiaries, can cause greater tax consequences than if the target company's assets were directly purchased in a §337 sale under existing law.

In sum, we question whether the "all-or-nothing" approach of the new §338 election does achieve symmetry, or is practical, with respect to the treatment of affiliated corporations. We believe that some exceptions to this approach are necessary in order to permit the legislation to attain its intended results -- symmetry between direct and indirect purchases of assets -- without unduly influencing other related tax policy issues arising in the context of an acquisition.

We appreciate the opportunity to present our views on this important subject. If you or your staff have any questions regarding our comments, please contact me at 862-6258.

Senator **Danforth**. Gentlemen, we thank you very much.

The next panel, Leon Sullivan, John Lapidakis, Hendrik Koning, David Johnson.

Mr. Sullivan, please proceed.

STATEMENT OF DR. MAURICE DAWKINS, ON BEHALF OF REV. LEON SULLIVAN, FOUNDER AND CHAIRMAN, OPPORTUNITIES INDUSTRIALIZATION CENTERS OF AMERICA, WASHINGTON, D.C.

Mr. **Dawkins**. Mr. Chairman, I am representing Rev. Leon Sullivan. My name is Dr. Maurice Dawkins. I have his testimony which I would like to read into the record.

Senator **Danforth**. All statements will be included in full in the record. If you would like to summarize.

Mr. **Dawkins**. I would like to make a few brief comments, if I might.

Thank you.

Mr. Chairman, this bill, S. 2224, is regarded by Rev. Leon Sullivan as a timely presentation to the committee. We would hope that the committee would give favorable consideration to it.

We know that at this time private funds are being looked to and the private sector is being looked to as a substitute or at least a supplemental to the public funds which are diminishing, for the kind of work that this bill anticipates needs to be done. We know that targeting to the handicapped, to the displaced workers, and to the economically disadvantaged of certain employment and training services will prepare them to earn their own way and to make their way off of the welfare rolls and out of the poverty level.

We hope that it would be possible for Senator Specter's bill, which would amend the Internal Revenue Code of 1954—to allow a credit against tax for contributions to programs providing job training for the disadvantaged, the handicapped or the displaced workers, to earmark 20 percent of the qualified job training charitable contributions of the taxpayer, up to a maximum of $250,000—would be given positive support by this committee.

The concept of targeting this tax credit to encourage charitable giving to qualified job training organizations certified by the Department of Labor is regarded by Reverend Sullivan as a practical approach to the problem we are facing in community based organizations such as the OIC, the Opportunities Industrialization Centers, the National Urban League, Operation SARE and other employer and union-sponsored job training programs.

We feel especially strongly about this bill and the needs that it would meet because of the tragic picture of high unemployment that we see today, up to 50 percent minority youth as well as the high unemployment rate, 10.5 million people unemployed.

We know there are some questions with reference to the comparability of the value of this kind of amendment and what would happen as a result of its passage as compared with the targeted tax credit legislation which has already been passed, which is already on the books, but we feel that in this particular era, in this time in our history as a nation, there is a need for reexamination and reevaluation of the ways in which people do give to charitable causes.

The targeting toward specific needs for jobs and job training seems to be justified to us—not as a substitute for, but supplemental to the targeted tax credit.

Additional programs might be developed, and programs that might be otherwise going out of business might be saved by very small contributions; sometimes a $5,000 or a $10,000 addition to a budget will keep the doors open in a center that is providing jobs and job training for people who need them.

Let us share with you, Mr. Chairman, some of our experiences in the State of Pennsylvania where the Community Affairs Department has the responsibility for implementation of the Pennsylvania State Neighborhood Assistance Act, which is similar to the bill introduced by Senator Specter. Organizations like ours can receive gifts from individuals or businesses in services, goods, or money. The donor gets a tax writeoff as long as the money is used to foster the goals of the organization. The State audits both the donors and the recipients each year.

This bill was passed in 1968, and the OIC's and the State have taken part in it since the beginning. We find that the system works well, it provides an incentive for private sector contributions that is practical. As a matter of fact, we are hoping that it will be possible to share with you in an appendix to this testimony the experiences we have had with other centers in the State of Pennsylvania and also with centers in the State of Missouri and Virginia.

[The prepared statement of Rev. Leon H. Sullivan follows:]

TESTIMONY

Submitted by

The Reverend Leon H. Sullivan
Founder/Chairman
O.I.C. of America

TO

The Senate Finance Committee
Hearing on S 2224

A Tax Credit Incentive
For Charitable Contributions To Job Training Organizations

Thursday, July 15, 1982
U.S. Senate Office Building
Washington, D. C.

Mr. Chairman and Members of the Committee

My name is Leon Sullivan.

I come to this hearing with genuine feelings of appreciation for the efforts that this committee is making to provide legislation that will help lead the nation out of the darkness of depression and recession.

The role of the Senate Finance Committee in bringing some balance and equity to the taxation system through much needed reform has become one of the encouraging facts in a generally discouraging picture.

The committees attempt to assure sacrifice on the part of all segments of the population and prevent an unfair and unacceptable burdening of the poor and disadvantaged is especially gratifying.

I must say Mr. Chairman that your corrective medicine as prescribed for the truly greedy in our nation has been noted with genuine satisfaction by those of us who have dedicated our lives to working on behalf of the truly needy.

It is against this background that I have come today to testify in support of S-2224, the bill introduced by my own Senator (and my friend) the Honorable Arlen Specter of Pennsylvania.

Senator Specters' Bill to amend the Internal Revenue Code of 1954 to allow a credit against tax for contributions to programs providing job training for the disadvantaged, the handicapped and the displaced workers is a bill that I can whole heartedly endorse.

The idea of earmarking 20% of the qualified job training charitable contributions of the taxpayer up to a maximum of $250,000.00

is an excellent plan consistent with today's economic retrenchment, and the reduction of public funds for job training.

The concept of targeting this tax credit to encourage charitable giving to qualified job training organizations certified by the Department of Labor is certainly a practical approach to the problem we are facing in community based organizations such as O.I.C. (Opportunities Industrialization Centers), the National Urban League, Operation SER and other employer and union sponsored job training programs.

Perhaps I feel so strongly about this bill and the needs that it would meet because of the tragic picture of high unemployment among the disadvantaged, the displaced workers and the handicapped, the three groups that this bill specifically selects for special consideration.

We in O.I.C. are currently in the midst of retrenchment. We have cut back from 150 to 128 programs. We have closed down 8 regional offices, we have come down from a budget of 135 million dollars, to approximately 100 million dollars a loss of 35 million. Our capacity to deliver employment and training services has thus been cutback significantly and we too have to target our limited funds more carefully to those who need them most.

In so doing we have had to experience the heartbreak of having to eliminate from our programs some who are in real need but are not as needy as others.

Additional funds that might be contributed to our programs by private individuals who will have the targeted tax credit as an incentive could make a real difference.

Very often, $15,000.00 would keep a program going that could reach 100 needy and disadvantaged or displaced workers. Our cost effective program has made it possible to train a person for $1,500. Cooperating businessmen are willing to work with us as partners, but we need the private funds to enable us to keep the training and the basic cost of operations covered.

I can see how inclusion of this bill in the Revenue Tax Code will encourage giving that in turn would make possible a maintenance of effort in many of our smaller O.I.C.'s across the country.

Let me share with you, Mr. Chairman some of our experiences in the State of Pennsylvania.

Our State Department of Community Affairs has the responsiblity for implementation of the Pannsylvania State Neighborhood Assistance Act which is similar to the Bill introduced by Senator Specter. Organizations like ours can receive gifts from individuals or businesses in services, goods or money.

The donor gets a tax write off as long as the money is used to foster the goals of the organization. The state audits both the donors and the recipients each year.

This bill was passed in 1968 and the O.I.C.'s in the state have taken part in it since the begining.

We find that the system works well, it provides an incentive for private sector contributions that is practical.

We in O.I.C. strongly favor the bill and two of our staff members have prepared supplementary testimony which I have asked to have submitted under separate cover.

One man, who was the Director of Business Development for the Pennsylvania State Department of Commerce knows first hand how well it has worked with organizations other than O.I.C. throughout the state.

The second man was the State Economic Opportunities Director for the State of New Jersey which passed a similar act that has been working quite well.

He also served as President of the National Association of State Economic Development Directors and helped get similar legislation enacted in the States of Virginia and Missouri where he reports it has also proved to be a very valuable resource for community organizations.

The experience of these states and our own experience in my organization have convinced me that this Sepcter Bill will make a significant contribution if your committee will include it as a amendment to the current tax package being considered by the Finance Committee.

I wish to commend Senator Specter and to urge Senator Dole as Chairman, Senator Long as Ranking Minority Member, and the other Members of the Committee to do everything they possibly can to see that this concept is enacted into law. At this time in American History it is desparately needed.

Thank you for hearing my views on this matter.

The Chairman. Thank you very much, Mr. Dawkins.

I am not certain in which order you wish to proceed.

All right, fine.

STATEMENT OF JOHN E. LAPIDAKIS, EXECUTIVE DIRECTOR, KURTZ TRAINING CENTER, BETHLEHEM, PA., ON BEHALF OF THE NATIONAL ASSOCIATION OF REHABILITATION FACILITIES AND THE EMPLOYMENT TASK FORCE OF THE CONSORTIUM CONCERNED WITH DEVELOPMENTAL DISABILITIES, WASHINGTON, D.C.

Mr. Lapidakis. I am John Lapidakis. I am the executive director of the Kurtz Training Center in Bethlehem, Pa. I am here today representing the National Association of Rehabilitation Facilities and the Employment Task Force of the Consortium Concerned with the Developmentally Disabled. NARF represents over 700 rehabilitation facilities in the United States which provide vocational and physical rehabilitation services to more than 300,000 persons annually. The Consortium's employment task force is made up of the Association for Retarded Citizens, the Epilepsy Foundation of America, Goodwill Industries of America, the National Association of Private Residential Facilities for the Mentally Retarded, the National Association of Rehabilitation Facilities, the National Easter Seal Society, the National Society for Children and Adults with Autism, and the United Cerebral Palsy Associations, Inc.

I am here today to testify in support of S. 2224, a bill to provide tax credits for contributions to job training programs. I am pleased that Senator Arlen Specter of my State of Pennsylvania has introduced this legislation which will help support job training for handicapped persons conducted by nonprofit organizations represented by members of the Employment Task Force.

We are pleased that S. 2224 recognizes the need for job training programs for disabled persons. Employment is a priority issue for disabled people. In fact, the lack of specialized training, and employment opportunities can be just as much of a handicap as the disability itself. This program is aggravated by declining support programs at the same time that training programs for employment are being reduced and high unemployment rates close doors in the workplace.

The Employment Task Force represents well over a thousand nonprofit local community organizations which provide rehabilitation, training, and placement services to tens of thousands of disabled persons every day. The task force also includes major advocacy organizations that seek out job opportunities for disabled persons.

Funding for these organizations' training programs has traditionally come from a variety of sources. The State-Federal vocational rehabilitation program and the Comprehensive Employment and Training Act have been important sources of funding for job training. Other sources include mental health funds, social service block grants and many State and local government programs as well as private insurance referrals and workmen's compensation cases.

Contributions from individuals and corporations are essential to most programs providing job training to disabled persons. Governmental funding often does not cover the full costs of providing job training. Many ancillary services such as special transportation, adaptive devices, and modified training programs are not covered by the governmental funding source.

Dependence on non-Government funding is becoming more acute as Federal funding sources are cut back. The Federal budget recently passed by Congress will curtail direct funding of training programs and there will be an even more serious cutback for funding ancillary services necessary for disabled persons to participate in the training programs.

S. 2224 would not only provide a much needed source for revenue for job training programs, it would also provide a vital link between the private, nonprivate sector and the business community. Businesses are quite often wary of programs that involve governmental funding. It is all too often associated with redtape, interference, excessive administrative costs, and results that are not worth the hassle.

Where the business community and the job training program have been able to work directly together, the results have been gratifying.

Senator Specter based Senate bill 2224 on the neighborhood assistance programs in Pennsylvania. That program offers State business tax credits for Pennsylvania corporations who contribute to community service projects. I can attest from personal experience the effectiveness of that program.

In 1973 my Kurtz Training Center facility was engaged in a major fund drive to expand facilities to be able to serve more disabled persons in the Lehigh Valley, Pa., area. Because of the Neighborhood Assistance Act, we received many more contributions from the business community than had been expected. As important as the money was the relationships we developed with the business community which were just as important. Many of these businesses have now taken an ongoing interest in our programs.

We urge your support of this legislation.

[The prepared statement of John E. Lapidakis follows:]

Statement Of

John E. Lapidakis
Executive Director

Kurtz Training Center
Bethlehem, Pennsylvania

Representing

The National Association of Rehabilitation Facilities

And

The Employment Task Force
Of
The Consortium Concerned With The Developmentally Disabled

Before

The Finance Committee
United States Senate

July 15, 1982

Mr. Chairman:

My name is John Lapidakis. I am Executive Director of Kurtz Training Center in Bethlehem, Pennsylvania. I am here today representing the National Association of Rehabilitation Facilities and the Employment Task Force of the Consortium Concerned with the Developmentally Disabled. NARF represents over 700 rehabilitation facilities in the U.S. which provide vocational and physical rehabilitation services to more than 300,000 persons annually. The Consortium's Employment Task Force is made up of the Association for Retarded Citizens, the Epilepsy Foundation of America, Goodwill Industries of America, the National Association of Private Residential Facilities for the Mentally Retarded, the National Association of Rehabilitation Facilities, the National Easter Seal Society, the National Society for Children and Adults with Autism and the United Cerebral Palsy Associations, Inc.

I am here today to testify in support of S. 2224, a bill to provide tax credits for contributions to job training programs. I am pleased that Senator Arlen Specter of my state of Pennsylvania has introduced this legislation which will help support job training for handicapped persons conducted by non-profit organizations represented by members of the Employment Task Force.

We are pleased that S. 2224 recognizes the need for job training programs for disabled persons. Employment is a priority issue for disabled people. In fact, the lack of specialized training and employment opportunities can be just as much of a handicap as the disability itself. This problem is aggravated by declining support programs at the same time that training programs for employment are being reduced and high unemployment rates close doors in the work place.

People with disabilities want to be as independent and self sufficient as possible. They want to make their own living. However, because of their disabilities, handicapped people often need special training and assistance. Many grew up prior to the enactment of Public Law 94-142 and did not benefit from special education programs. They were never given an opportunity to develop basic skills. In addition to basic work skills, disabled people need specialized training to help compensate for their disabilities and to develop marketable skills. Once these skills are developed and jobs are secured, disabled people become self sufficient and they contribute to national productivity.

In addition to providing skill development for disabled people, we must also work with employers. They need training, encouragement and incentives. Even when a given disability is unrelated to the work required, employers tend to avoid hiring the handicapped. As a result, unemployment for disabled people is more than twice the national average. It is comparable to and often greater than the rate for youth and minority groups for which employment programs are targeted. Underemployment is an even greater problem. Because of their disabilities, handicapped people are often relegated to the most menial of tasks, and they are not considered for promotions in spite of enormous potential for growth.

The Employment Task Force represents well over a thousand non-profit local community organizations which provide rehabilitation, training and placement services to tens of thousands of disabled persons every day. They provide quality services to disabled persons in their community. They cooperate with state agencies and other non-profit organizations to identify the needs of disabled persons and provide them with the services needed to realize the fullest potential of the disabled person. Placement of disabled persons into the competitive, non-subsidized labor market is the goal of these organizations. The Task Force also includes major advocacy organizations that seek out job opportunities for disabled persons.

Funding for these organizations' training programs has traditionally come from a variety of sources. The state-federal vocational rehabilitation program and the Comprehensive Employment and Training Act (CETA) have been important sources of funding for job training. Other sources include mental health funds, social service block grants and many state and local government programs, as well as private insurance referrals and workers compensation cases.

Contributions from individuals and corporations are essential to most programs providing job training to disabled persons. Governmental funding often does not cover the full costs of providing job training. Many ancillary services, such as special transportation, adaptive devices and modified training programs, are not covered by the government funding sources.

Dependence on non-governmental funding is becoming more acute as federal funding sources are cut back. The federal budget recently passed by Congress will curtail direct funding of training programs and there will be an even more serious cutback for funding ancillary services necessary for disabled persons to participate in the training programs.

S. 2224 would not only provide a much needed source of revenue for job training programs, it would also provide a vital link between the private, non-profit sector and the business community. Businesses are quite often wary of programs that involve government funding. It is all too often associated with red tape, interference, excessive administrative costs and results that are not worth the hassle.

Where the business community and the job training programs have been able to work directly together, the results have been gratifying. An excellent example has been the Projects With Industry (PWI) program, funded by the Rehabilitation Services Administration and the Department of Labor. Under these programs, rehabilitation facilities and the local business community establish a joint council to identify real job needs in the community, set training standards needed for the actual jobs available and identify and place disabled persons into training programs that will qualify them for the already identified jobs. In the RSA project, this program provided jobs to over 9,000 disabled persons in one year at an average cost of less than $1000 to the federal government. The percentage of persons placed into private sector, non-subsidized jobs has averaged over 75%. The savings in income maintenance no longer needed and taxes now paid by these disabled individuals has by far exceeded the cost of the program.

Similar programs can be financed without any government assistance if the business community will take full advantage of S. 2224. We hope that businesses' investment in job training programs will encourage their active participation in and support of the job training activities of the community organizations. S. 2224 should not be viewed as a charity program but rather an opportunity to form meaningful partnerships between the business community and the private nonprofit organizations that can provide trained workers for those businesses.

It is important that disabled persons be included in the mainstream of the competitive labor market. Organizations helping to train disabled persons for employment will have to move into the high technology jobs that will be the mainstay of our economy. This will necessitate a closer working relationship between the business community and the community organizations I am speaking for today.

Senator Specter based S. 2224 on the Neighborhood Assistance Program in Pennsylvania. That program offers state business tax credits for Pennsylvania corporations who contribute to approved non-profit projects. I can attest from personal experience the effectiveness of that program. In 1973 Kurtz Training Center was engaged in a major fund drive to expand facilities to be able to serve more disabled persons in the Lehigh County area. Because of the Neighborhood Assistance Program, we received many more contributions from the business community than had been expected. They came from large and small businesses alike. As important as the money was, the relationships we developed with the business community were just as important as the money we received. Many of these businesses have now taken an ongoing interest in our programs and they have become an important source of placement for our trainees. Other rehabilitation facilities in Pennsylvania have had similar experiences.

With regard to the specifics of S. 2224, NARF and the other members of the Employment Task Force endorse the bill and the intent of the bill.

We do have one suggestion, however, with respect to the definition of a qualified job training organization. Section (c)(3)(B), lines 8-13 on page 5 state that the organization must be certified by a regional office of the Employment and Training Administration of the Department of Labor. I am not aware of any certification program currently being used by the Department of Labor. Under the CETA program, service providers are chosen by the local Prime Sponsor. In the definition of community-based organizations in the current CETA Act and S. 2036, the Senate proposal to replace CETA, rehabilitation facilities and agencies serving the handicapped are specifically included as potential service providers.

Rather than requiring the Department of Labor to develop a separate certification program for S. 2224, we suggest that in lieu of DOL certification, the recipient job training organization have appropriate state, federal or other certification or accreditation. Types of existing certification and accreditation for agencies providing job training to disabled persons include appropriate professional accrediting bodies, state licensing and Department of Labor wage certificate for training programs under Section 14(c) of the Fair Labor Standards Act. Report language could suggest these various alternative forms of certification or accreditation.

We hope that Congress will also consider, in the future, additional incentives for private industry to become more directly involved in job training for disabled persons.

Thank you for this opportunity to testify on behalf of NARF and the Employment Task Force and the organizations and disabled persons they represent.

MEMBERS

EMPLOYMENT TASK FORCE

Of The

CONSORTIUM CONCERNED WITH THE DEVELOPMENTALLY DISABLED

Association for Retarded Citizens

Epilepsy Foundation of America

Goodwill Industries of America

National Association of Private Residential Facilities for the Mentally Retarded

National Association of Rehabilitation Facilities

National Easter Seal Society

National Society for Children and Adults with Autism

United Cerebral Palsy Associations, Inc.

Senator DANFORTH. Mr. Koning?

STATEMENT OF HENDRIK KONING, SPECIAL ASSISTANT FOR URBAN AFFAIRS, PHILADELPHIA ELECTRIC CO., AND DIRECTOR, HIGH SCHOOL ACADEMIES PROGRAM, PHILADELPHIA, PA.

Mr. KONING. Mr. Chairman, my name is Hendrik Koning, and I am employed by the Philadelphia Electric Co. and have been an executive on loan to the Philadelphia Urban Coalition since 1972.

As director of the high school academies, I have had the privilege to see the academies grow from a pilot project to programs which presently have a student body of 650 students and $350,000 in corporate contributions, which includes the inkind contributions. A recently completed study from Temple University has recommended that this unique program be expanded to 1,500 students.

May I begin with a small historical sketch as to the origin of the academies. After the civil disorders about 14 years ago, the Philadelphia Urban Coalition was formed.

One of the first efforts for effective community outreach by this coalition was an attempt to build a model for career educations through an effective partnership between business and the school district. In 1969 the first academy was organized, which is now the Academy of Applied Electrical Science, Inc.

It was decided that the academy effort would be directed toward students entering high school, as the greatest dropout rate seems to occur after the age of 16 during the high school years.

The first question we tried to answer was: under the given adverse and discouraging circumstances, in a setting such as north Philadelphia, is it possible to design a program for students who are disadvantaged by having low basic skills, who did not have the qualifications for entering vocational schools, which would motivate them to the extent that the minimum objective of employability could be achieved. And it is to this question that we now can say yes.

The second question we raised after developing the program, could it be applied to other career clusters? The result of that can be answered in the affirmative. We have now a Business Academy, Inc., an Academy of Applied Automotive and Mechanical Sciences, and the Philadelphia Health Academy which, by the way, is now supported by the major union, the 1199C.

The third question that we had to answer, are they replicable, and the recently completed studies indicate that the conditions which have to be met for success can be spelled out.

I would like to share with you some of the underlying philosophy which I believe makes such programs successful. The components which make up this program are not new. On the contrary, they have been well known in educational circles for a long time. What is new is that they are brought into focus. The academy program is holistic.

Back to basics is becoming a popular slogan. Back to a holistic approach I think is more an effective answer to educate disadvantaged students, and others as well.

Time does not permit me to go into details. I would like to sum up some of the factors contributing to such success.

One is an interdisciplinary project team with representation from business, industry, labor, school district, and the academic community working hand in hand and given the freedom to act.

Two, the hands-on individualized stepped program.

Three, the curriculum development of each industry is involved to make the transition from school to work.

Four, a survival package. A factory in the school which operates so that disadvantaged youngsters too young to be placed in industry can earn pocket money and be provided with real work experience.

We feel that we have learned how to do it.

A few words on the funding. Federal funding was not accepted, so that personnel in the projects could concentrate on development and would not have to deal with the intricacies of Federal bureaucracy. The incremental cost is still subscribed by industry.

But guiding young people toward a realistic attitude toward work is a major task. How can we teach a work ethic without work? It is to these components of the work experience and to stimulate industry to undertake that that I hope that this bill will be an incentive.

Thank you for the opportunity.

[The prepared statements of Hendrik Koning and John L. Thompson follow:]

HEARING BY U.S. SENATE
FINANCE COMMITTEE ON S. 2224

ON JULY 15, 1982

TESTIMONY GIVEN BY:

Hendrik B. Koning, Special Assistant
for Urban Affairs
Philadelphia Electric Company

and

John L. Thompson, Program Coordinator
Academy of Applied Electrical Science, Inc.

Mr. Chairman:

My name is Hendrik B. Koning. I am employed by the Philadelphia Electric Company and have been an executive on loan to the Philadelphia Urban Coalition since 1972.

As Director of High School Academies, I have had the privilege to see the Academies grow from a pilot program to programs which presently have a student body of 650 students and $350,000 in corporate contributions, which includes the inkind contributions. A recently completed study from Temple University has recommended that this unique program be expanded to 1500 students.

May I begin with a small historical sketch as to the origin of the Academies. After the Civil disorders, about 14 years ago, The Philadelphia Urban Coalition was formed.

One of the first efforts for effective community outreach by this Coalition was an attempt to build a model for career education, through an effective partnership between business and the school district. In 1969 the first Academy was organized, which is now the Academy of Applied Electrical Sciences, Inc.

It was decided that the Academy effort would be directed towards students entering high school, as the greatest dropout rate seems to occur after the age of 16 during the high school years.

The first question we tried to answer was: Under the given adverse and discouraging circumstances, in a setting such as North Philadelphia, is it possible to design a program for students, who are disadvantaged by having low basic skills, and who did not have the qualifications for entering vocational schools, which would motivate them to the extent that the minimum objective of employability could be achieved? It is to this question that the Academies can give a positive answer.

The second question we raised after developing the program in the electrical and electronic field was: Can this "Academy style" be applied to other career clusters?

We feel that we can answer this question also in the affirmative. The Philadelphia Business Academy, Inc, the Academy of Applied Automotive and Mechanical Sciences, Inc., and the Philadelphia Health Academy are the result of trying to answer this question.

The third question was: Are they replicable? Recently completed studies indicate the conditions which have to be met for success.

I would now like to share with you the underlying philosophy which I believe makes the Academy program successful. The components which make up this program are not new; on the contrary they have been well known in educational circles for a long time. What is new is that they are brought into focus. The Academy program is holistic.

Back to basics is becoming a popular slogan. Back to a holistic approach, I feel would be more effective for disadvantaged students and others as well.

Time does not permit me to go into many details. I would like to sum up some of the factors contributing to the success of the Academy:

1. The interdisciplinary project team, with representation from business, industry, labor, the school district and the academic community, is given the freedom to act and is able to develop a results-oriented program.

2. The "hands-on" individualized stepped program with the development of the basic skills directly related to vocational skills leads to greater motivation of the student.

3. The curriculum development takes place under actual teaching conditions, with direct feedback, so that improvements can be made immediately.

4. The operation of a "survival package." A factory in the school which operates after schools hours and during summer months, so that disadvantaged young people, too young to be placed in industry, can earn pocket money and be provided with real work experience at the same time.

We feel that what we learned with our work with disadvantaged students could be equally valuable for students who are not disadvantaged.

A few words on development and funding:

From the beginning the development of the program was under the auspices of top executives in business and the school district.

A low profile was maintained during the development period so that the atmosphere would be conducive to responsible experimentation, and not subjected to political pressures.

The Academies, as non-profit organizations, are neutral ground where labor, management and the educational system can cooperate in what is their common interest - the education of the future work force.

As for funding. Federal funding was not accepted so that personnel in the projects could concentrate on development and would not have to deal with the intricacies of the Federal bureaucracy. The incremental cost is still subscribed by business and industry.

Guiding young people towards a realistic attitude towards work is a major task. But how can we speak about developing a work ethic without work? To create work experience for these inner city young people is the major obstacle in expanding the Academies.

We have used various Federal youth programs for making available real work experience. Most of them, including this year's, have been a disaster - appropriations become available when good industrial slots are already filled for months.

Since 1967 the Commonwealth of Pennsylvania, through its Neighborhood Assistance Act, has encouraged many companies to become involved in the education of the disadvantaged. Unfortunately this Act does not have a financial incentive for work experience.

Hopefully this bill S. 2224 will create this incentive so that this crucial element in the educational and training process will be addressed.

7/14/82

Mr. Chairman:

My name is John L. Thompson. I am a teacher in the Philadelphia public high school system and the Program Coordinator of the Academy of Applied Electrical Science, Inc. This is a unique industry-supported, career-focused program for inner city students, a "school-within-a-school" at Edison High School in North Philadelphia. One hundred young men and women are enrolled in our tenth through twelfth grade program. It is a small program but it has been operating for nearly fourteen years and has produced dramatic results. Students attending our program show much higher attendance rates and academic achievement than many of their peers. And, when they graduate, they are highly employable.

The Electrical Academy is jointly sponsored by the Philadelphia School District and the private sector, including nearly thirty businesses currently. Because of the importance of the Pennsylvania tax credit to our program, I would like to testify in favor of the Federal tax credit for job training as proposed in Senate Bill 2224.

Allow me to illustrate the effect that corporate involvement can have upon disadvantaged young people in preparing them for the world of work.

Edison High School, the parent public high school for our Academy, is in an impoverished section of North Philadelphia. Seventy percent of the students come from families receiving AFDC (Aid To Families With Dependent Children). All the problems of the community are, of course, mirrored in Edison High School.

Our Academy was designed to meet the needs of under-achieving inner city youth who, without a program of education and training that speaks directly to their needs, will probably drop-out of school and become unemployed and unemployable welfare recipients.

Here is how corporate involvement has helped our program:

1. Personnel from local corporations have been loaned in many capacities, both full and part-time. For example, employees have worked as project managers, instructors, curriculum developers, committee members, and student counselors.

2. Industry has made important contributions of up-to-date equipment and materials.

3. Supporting companies have provided part-time, summer jobs, and permanent employment.

4. Corporate financial support funds the supervision of our after school and summer work experience program. This means that our program is open 8 to 5 p.m. every day, year round.

The benefits our program has produced are several:

- Businesses have found a source of better prepared and motivated employees.

- The Academy has had a strong, positive impact on the entire school. Morale is high among teachers who work with the Academy. They see students change. They feel good about teaching every day because they see results.

- The Academy has also had a positive influence on other vocational programs in Philadelphia.

- The inner city community has benefited because more families are demanding quality education and training for their children.

- But most of all, the benefits go directly to our students. They are able to build productive lives and careers. I can give you many specific examples where I have seen the welfare dependency syndrome broken. Students come from families where the expectation is that the children will end up on welfare. A summer job in industry has helped many of our students to feel that "I am somebody. I am working. I want to keep working." This attitude and hope has a way of spreading to others in that student's family and to his friends.

Our experience says that tax credits to support this type of program are dollars well spent. I am sure you are aware of the staggering unemployment rates among inner city disadvantaged youth. An Academy type of program offers a proven preventative solution to youth unemployment. It offers relevant training and education to young people. Young people are given employability skills while in school. This is much more efficient than trying to reach them after they have dropped out.

Our approach works. While the overall school attendance rate is perhaps 55%, the Academy's has been 90% for several years. The Academy has had a drop out rate of only 1% or 2% (and sometimes 0%) per year compared to 30% for the school. 90% to 100% of our graduates each year are employed or continue their education. Young people in danger of being alienated from the educational system and strangers to a working way of life are now leaving school with their diplomas in hand and on their way to jobs.

Without the partnership of schools and corporations, these results would not have happened. The federal tax credit that is proposed in Senate Bill 2224 will encourange the replication of our results on a nation-wide basis.

Senator **Danforth**. Mr. Thompson.

STATEMENT OF JOHN L. THOMPSON, PROGRAM COORDINATOR, ACADEMY OF APPLIED ELECTRICAL SCIENCES, PHILADELPHIA, PA.

Mr. **Thompson**. Mr. Chairman, my name is John Thompson. I am the program coordinator for the Academy of Applied Electrical Science. This is a unique industry-supported, career-focused program for the inner city student, a school within a school at Edison High School in north Philadelphia; 100 young men and women are enrolled in our 10th through 12th program. It is a small group but it has made tremendous movement in the 14 years it has been in existence.

Students attending our program show much higher attendance rates and academic achievement that many of their peers admire. When they graduate, they are highly employable.

The Electrical Academy is jointly sponsored by the Philadelphia School District and the private sector, including many, or nearly 30 businesses, and currently more will come.

Because of the importance of the Pennsylvania tax credit to our program, I would like to testify in favor of Federal tax credit for job training as proposed in bill 2224.

Allow me to illustrate the effects that corporate involvement can have upon disadvantaged young men and women in preparing them for the world of work. Edison High School, the parent public high school for our program, the academy, is in an impoverished section of north Philadelphia; 70 percent of the students come from families receiving AFDC. All the problems of the community, of course, mirror into Edison High School. Our academy was designed to meet the needs of underachieving inner-city youth. Without a program of education and training that speaks directly to their needs, they probably will drop out or become unemployed or unemployable welfare recipients.

Here is how the corporate involvement has helped our program. Personnel from local corporations have been loaned in many capacities, full time and part time. For example, employees have worked as project directors and managers, instructors, curriculum developers, committee members, and counselors to students. Industry has made important contributions to update equipment and material. Supporting companies have provided part time and summer employment and permanent employment. Corporate financial support funds provide supervision for after-school and summer experience work programs. This means that our program operates 8 to 5 every day, all year round.

The benefits of our products are several. Businesses have found a source of better prepared and motivated employees. The academy has a strong positive impact on the entire school. Morale is high among the teachers who work with the academy. They see changes in students. They feel good about teaching every day because they see results.

The academy has also had positive influence on other vocational programs in the Philadelphia area. The inner-city community has benefited because families are demanding quality education.

As we see it, the people of the Electrical Academy, the bill S. 2224 would aid in these types of programs because it would bring about better attendance within inner city community schools.

Thank you.

Senator **Danforth**. Thank you.

Mr. Johnson?

STATEMENT OF DAVID G. JOHNSON, MANAGER OF NEIGHBORHOOD PROGRAMS, DEPARTMENT OF CONSUMER AFFAIRS, STATE OF MISSOURI, JEFFERSON CITY, MO.

Mr. **Johnson**. Thank you.

My name is David Johnson and I am employed in the State of Missouri as the manager of neighborhood programs for the division of community and economic development.

I want to thank you very much for the opportunity to present my views today, and I would also like to thank Senator Arlen Specter from the State of Pennsylvania for asking me to come and share my experience with State tax credit programs.

During the past 3 years, my primary responsibility in State government has been the administration of Missouri's Neighborhood Assistance Act. This legislation allows tax credits for corporations who become involved in financially supporting community service and community development projects which have been approved by the State. Typically these projects are sponsored by community-based nonprofit agencies. Although the law does permit business firms to propose and carry out their own projects, this is not the normal pattern. The law sets out several categories of programs which are eligible for approval by the State. They include community services, crime prevention, educational programs, job training as well as physical revitalization efforts. The types of projects which have been carried out through partnerships of business firms and community-based organizations include senior citizen centers, child day care centers, mental health programs, job training programs such as the opportunities industrialization centers in Kansas City and St. Louis, as well as neighborhood housing rehabilitation programs and commercial revitalization efforts.

Typically, the involvement of the companies takes the form of charitable contributions, but oftentimes will also include the commitment of personnel and materials to projects.

In addition to Missouri and Pennsylvania, similar legislation has been passed in other States including Florida, Indiana, Michigan, Delaware, and lately, Virginia. Bills have been introduced over the past several years or are currently being considered in Louisiana, Ohio, Illinois, Massachusetts, Kansas, Arizona, Nebraska, Kentucky, and Maryland.

Tax credits have been used for some time to stimulate economic decisions by the business community in making certain investments in their productive capacity. These laws are somewhat unique in that they utilize the same type of incentive to encourage investments in the improvement of quality of life in communities.

In Missouri we feel the program has been quite successful. Over the past 2 years corporations in our State have contributed over $4½ million to projects which have been approved by the State.

During this last session of our general assembly the law was expanded to include also sole proprietorship and partnership businesses.

I am not convinced that the same type of success would come about with the direction and guidelines for individual projects coming from a Federal agency. It is my feeling that Federal legislation in this area should be directly linked to State-enacted programs. The burden of deciding if it is an appropriate mechanism should be left to State legislatures. However, the State should not be taxed if they do select to participate in it.

I would suggest that the Federal response should be tied in correcting problems which result from the interaction between the State and Federal tax systems.

Currently, half of all the tax credits provided by States in programs such as these and also State enterprise zone legislations are paid back to the Federal Treasury in the form of increased business taxes. What results is essentially a windfall for the Internal Revenue Service. Clearly this is an unfortunate situation. Not only does it result in the weakening of the value of the State incentives, but it also makes the Federal Government and not the distressed communities the beneficiaries of these State policies.

I would suggest that the consideration of these tax credits or similar tax credits as taxes paid would be a much more appropriate response in terms of State policy directions.

I must point out that this would not result in any actual revenue loss to the Federal Treasury, but rather, the elimination of an unanticipated windfall from State tax policies.

Senator Danforth. Thank you very much, Mr. Johnson.

Thank you especially for coming here from Jefferson City, my own hometown.

You believe that in our State this program has the effect of increasing jobs? People are working now that would not be working were it not for this?

Mr. Johnson. Yes, sir, particularly in local housing and commercial revitalization projects. We are now getting a much greater degree of involvement of business firms in job training programs for youths as well. Our Governor has initiated a program, jobs for Missouri graduates. Several large firms in Kansas City have organized by job training program where they are supplying wages and supervisors to provide job experiences for young people.

The Chairman. Senator Danforth, I wasn't here when Senator Specter testified, and I am just very pleased that you are able to have these hearings, and I am glad you were presiding. I was involved in the food stamp markup. We finally finished. It seems like it has taken forever, but I note that Treasury makes a couple of suggestions in the event we might favorably consider this legislation. It seems to me if in fact it were enacted that we should require that the amount of the charitable contribution deduction be reduced by the amount of the credit, and I am not certain how much that reduces the cost. I have asked the staff to see what change that would make in the cost.

In addition, of course, we have just passed and extended—at least it is in our bill, if it passes—the jobs tax credit. We are in the process of now taking a look at that because very honestly, the cost estimates are $500 million greater than originally indicated. So we may have to shrink the size of that extension by at least $500 million.

Senator Heinz introduced that extension, and he has indicated he has a direct interest in this program, and he hoped to be able to be here before the hearings concluded. But we also last year increased the amount corporations can contribute from 5 to 10 percent. So there have been a number of efforts to encourage corporations to be good citizens, and most of them are.

We also, of course, might consider this as a possible candidate to include in the enterprise zone legislation which we will be having additional hearings on soon, if you help us pass the tax bill that is now on the Senate floor. If that fails, we will have to come back and work on that during the months of July and August.

So, I think based on these considerations, well, I certainly commend those of you who have worked with the program but I would note that it is also another bump in the road toward a flat rate tax.

We have had a lot of talk about a flat rate tax. This would certainly be another bump in the flat rate. We are talking about eliminating credits, deductions, exemptions. At the same time we are being asked to include another credit.

So based on those reservations, we certainly will carefully look at this, and we are going to try to conclude the Senate's markup on enterprise zones very soon, and I would suggest that you be alert to that because this might be a possible amendment.

Thank you very much.

[Whereupon, at 1:15 p.m., the committee recessed subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

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July 14, 1982

Honorable Robert J. Dole
Chairman, Committee on Finance
United States Senate
2213 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Chairman Dole:

This letter is written on behalf of Capital Holding Corporation for inclusion as a part of the record in the hearings before the Senate Finance Committee on July 15 on Senator Danforth's proposed amendment to the committee's revenue raising bill.

In January 1981 Capital Holding Corporation (Capital Holding) and its affiliates acquired the stock of National Home Life Insurance Company (National Home) for cash and debentures.

Since acquiring the stock of National Home, Capital Holding has been preparing for the partial liquidation of National Home's direct response business (the greater part of its business) into Commercial State Life Insurance Company (Commercial State), a Missouri life insurance company which it acquired in 1981 for this express purpose. The direct response business would then be conducted by Commercial State and the agency business would be conducted by National Home.

H.R. 6725 would, in effect, prohibit partial liquidations after August 31, 1982. Although this may be reasonable for corporations which can consummate a partial liquidation within a six week period, it is an inadequate period of time for Commercial State, a thoroughly regulated corporation whose operations are supervised in the thirty-eight states in which it does business. In this case, to accomplish the partial liquidation, Commercial State must obtain approval from the Superintendent of Insurance in the State of Missouri and in a substantial number of the other jurisdictions in which it writes insurance policies, and from a number of other states in which it intends to do business. For this reason, time is needed, at least until the end of 1982, within which to accomplish the partial liquidation of National Home.

We understand that this problem may be solved by a transitional rule which would, in the circumstances, described above, permit Commercial State to adopt a plan of partial liquidation before October 1, 1982. In addition, Capital Holding would not object to the enactment of legislation which would impose a recapture tax on National Home as the price for Commercial State obtaining a stepped-up basis for the assets received on the partial liquidation. Alternatively, Capital Holding recognizes and would favor the proposals to amend the consolidated return regulations to accomplish the same result and thus avoid the "overkill" effect of the proposed legislation.

Sincerely,

John Bipler

cc: John Andre LeDuc, Esquire

NATIONAL ECONOMIC DEVELOPMENT AND LAW CENTER
1990 "M" STREET, N.W., SUITE 450, WASHINGTON, D.C. 20036
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TESTIMONY

of

LEO FISHMAN
ATTORNEY/WASHINGTON COORDINATOR
NATIONAL ECONOMIC DEVELOPMENT
AND LAW CENTER

S.2224
TAX CREDIT FOR JOB TRAINING

before the

FINANCE COMMITTEE

of the

UNITED STATES SENATE

July 15, 1982

PRINCIPAL OFFICE
2150 SHATTUCK AVENUE • BERKELEY, CALIFORNIA 94704 • 415•548•2600

Good morning, Mr. Chairman. I am Leo Fishman, an attorney and Washington Coordinator for the National Economic Development and Law Center, a nonprofit public purpose organization headquartered in Berkeley, California. For thirteen years, the Law Center has worked to improve economic conditions in distressed communities by providing legal services, training, planning and project development assistance to a wide range of urban and rural community organizations throughout the United States. We have also advised federal, state and local government on programs and issues of public policy, and we have endeavored to promote public-private collaboration in community and economic development. Obviously, the training of economically disadvantaged persons has been one of our major concerns.

I am accompanied by Steven C. Davidson, an economic development consultant who has been studying the use of tax incentives as a tool for achieving social and economic benefits for distressed communities. Recently, Mr. Davidson wrote a report for the Law Center on Neighborhood Assistance Programs ("NAPs"), a series of state tax incentives designed to promote corporate and business contributions to projects deemed eligible under applicable state law.

S.2224, a bill providing federal tax credits for contributions to nonprofit job training organizations, is based on the state NAP programs. Therefore, I should like to present some observations on the experience of the states, and hope that the information might benefit the committee in its deliberations.

Pennsylvania, in 1967, was the first state to establish a NAP tax incentive, and later, similar programs were developed in Delaware, Michigan, Indiana, Florida, Missouri and (most recently) Virginia. More than twenty additional states are now considering the use of tax incentives undoubtedly because of the reduced flow of federal funds.

Typically, a NAP program works as follows: A project proposal is prepared by a sponsor (who will likely become the program operator) and submitted to a designated state agency for approval. When the project has been declared eligible, a business taxpayer such as a corporation may then invest in or contribute to it. As a result of this act, the contributor earns a financial incentive under state law in the form of a tax credit or deduction usually against income tax. Thus, by reducing the actual dollar cost of the contribution, the states try to encourage a higher level of private giving to alleviate problems of distressed communities.

Under the various state statutes, the scope of eligible activity encompasses a broad range of social and economic development programs such as:

- crime prevention
- job training
- educational/scholarship assistance
- medical services
- community (physical) improvement
- recreation
- entrepreneurial assistance

The definitions of project eligibility are not uniform among the seven states. Florida, for example, restricts its program to economic development such as housing rehabilitation, commercial/industrial development, business and job generation. Meanwhile, Pennsylvania will not approve a NAP proposal which will enhance private business activity. In all states, however, the focus is on the need of distressed communities.

The most commonly used financial incentive is the tax credit. Subject to an annual maximum limitation on the taxpayer and on the level of the entire state program, the contributor may take a credit equal to fifty percent of the amount of his contribution. Ironically, however, the state credit has the unintended side effect of enriching the federal treasury. To the extent of the benefit afforded the taxpayer, its ability to deduct state taxes from the federal return is commensurately reduced; the state credit therefore increases the amount of federal tax paid.

For a project to be eligible under state law, the sponsor/donee generally has to be a nonprofit corporation exempt from federal taxation under Section 501(c)(3) of the Internal Revenue Code. (A few states permit the contributor itself to serve as sponsor/program operator, but this is not a frequent occurrence.) Consequently, the contributor benefits from the federal charitable deduction as well as the NAP tax credit. Moreover, in Florida and Pennsylvania, the states permit a charitable deduction as well because of the coupling of state and federal tax systems. Consequently, in two NAP jurisdictions, the taxpayer enjoys three incentives: the NAP credit, the federal charitable deduction, and the state charitable deduction.

Because of the diversity among state programs, and the scarcity of quantifiable information, it is difficult to evaluate the effect of the NAP tax incentives. There have been substantial achievements, and yet, NAP has never approached the full realization of its potential. As noted earlier, Pennsylvania initiated its program more than 14 years ago, but it never approached the statewide maximum limit on annual credits ($8.75 million) until 1981. Missouri, with a high level of activity since the inception of its program in 1978, also experiences underutilization. Indiana (1976) and Florida (1980) have had difficulties in formulating program guidelines and establishing an effective administrative system. Delaware (1970) and Michigan (a tax rebate program) have never been able to get started. And Virginia began its program on July 1, 1982.

Several reasons contribute to the shortfall. First, the state agencies which administer NAP are, without exception, understaffed. In most instances, one person, and one person alone is responsible for reviewing proposals, informing applicants of project status, and doing the paperwork which is so necessary for coordinating the efforts of the program agency with the tax department. This means that no one is available to market the program among businesses and community groups, and no one is available to provide the technical assistance to package the projects. Second, and incidental to the absence of a marketing capability, the substantive requirements are neither communicated nor made clear among potential beneficiaries. A tax incentive is most effective when its terms and conditions are certain and predictable. Often, in NAP programs, vague qualifications for project eligibility discourage the applicant and the potential business contributor. Third, it has to be remembered that a NAP tax credit only works to reduce the cost of capital; by itself, it does not make available a sufficient supply of money, nor does it assure that worthwhile NAP projects are available to benefit the community. In a recessionary economy, it takes more than a tax credit to stimulate development activity in a distressed community.

For NAP programs to realize their full potential, these problems have to be remedied. But as you can see, they are not matters of severity and substance but merely the issues that evoke the need for administrative fine tuning. Overall, the programs present a record of substantial achievement. In Pennsylvania and Missouri particularly, the tax credits have stimulated a significant volume of corporate financial contributions for projects in distressed areas. Of greater importance - and this cannot be valued in terms of foregone tax revenue - is the fact that NAP has been the catalyst for active, intense personal involvement on the part of business executives. This has brought about a greater awareness of the problems of distressed communities without prejudice and without distortion. These are the necessary preconditions to solving these problems.

The purpose of S.2224 is to create incentives for business and corporate contributions to nonprofit job training organizations. While the scope of state NAP programs extends beyond employment and training, effective use of state tax credits has been made. Organizations in Pennsylvania, Indiana, and Missouri have used NAP to bring about corporate participation and funding and of youth employment programs.

In Columbia, Missouri, a Rural Youth and Housing Program provides training and work experience in the construction trades. At the same time, the project generates low cost housing availability for low and moderate income households. To participate in the program, priority is given to youth who are economically disadvantaged, to ex-offenders, to minorities, and to others in need of significantly improved employment opportunity. The program has qualified for $220,000 in NAP contributions which will qualify for a fifty percent state tax credit in 1982.

The Johnson County Association for Retarded Citizens received Indiana state Neighborhood Assistance Program support for its Rehabilitation Center for Mentally Retarded and Developmentally Disabled. The NAP funds go towards new equipment for its programs offered in the training of mentally retarded and disabled clients eighteen years and older. Tax credits worth $34,885 were approved in 1981.

In 1981, Indiana approved two youth employment programs. The Kosciusko County Youth Employment project educates and trains young men and women who are not enrolled in vocational and college programs so that they will become employable. The Muncie (Indiana) Community Schools for Youth Opportunity received NAP support for its Youth Employment Program.

Perhaps the best publicized NAP supported youth job training program is the Philadelphia Business Academy in Philadelphia, Pennsylvania. The Business Academy is a three-year high school business education program managed and supported with Pennsylvania state NAP tax credits. Twenty-five corporations sponsor the project whose annual budget is about $70,000. The students are disadvantaged youth interested in vocational and technical education. They are selected from among those who are unable to qualify for vocational schools. The participating corporations agree to provide part-time summer employment for the youth. The vast majority of the graduates are employed in jobs for which they were trained in the Academy.

Neighborhood Assistance Programs have also supported training programs for the disadvantaged which have been tailored to provide technical skills in specific industries.

Blue Hills Home Corporation, a nonprofit organization in Kansas City, Missouri, rehabilitates abandoned or severely deteriorated properties and then resells or rents them to low and moderate income residents. Missouri has authorized $59,000 of NAP funds eligible for fifty percent tax credits to maintain six housing rehab training slots in order to employ and train unemployed or underemployed persons in the area.

The Kansas City Corporation for Industrial Development has established the KCCID Charitable Fund to redevelop, attract new investment, and create jobs in the Kansas City area. The Fund is a public foundation designed to attract public and private contributions for leveraging location and expansion of inner-city firms. Missouri has authorized $175,000 of NAP funds eligible for fifty percent tax credits. The funds are used to induce use of the organization's job training programs.

Several projects have been supported by Neighborhood Assistance tax credits in Pennsylvania to train disadvantaged workers for employment in a specific industry. The Philadelphia Clothing Manufacturers Association supports its on-the-job training, Mens and Boys Apparel Industry project with NAP credits. Another example is the Adams-Hanover Area Sheltered Workshop which provides vocational education in construction for the disadvantaged.

S. 2224, the bill now before this Committee, will provide a federal tax credit to participating corporate taxpayers in an amount equal to twenty percent of their contributions to qualified, nonprofit job training organizations. As indicated in tables below, this will reduce the cost of the contribution and serve as a strong incentive for directing private resources to an area of public significance. While it has been difficult to measure the quantitative results, the credits have worked at the state level to influence corporate fund allocation decisions. Moreover, as noted earlier, the tax credit will have a substantial indirect effect of promoting greater personal involvement among members of the corporate community in the solution of problems of distressed communities.

Beyond the obvious benefits, legislation based on the state Neighborhood Assistance Programs presents several unique qualities:

> FIRST, the program will be a local program depending on the initiative of the sponsor/operator and contributors. As such, it will conform much more closely to local needs and available resources. In short, specific training operations can be developed and operated in close proximity to the problem.
>
> SECOND, by involving private contributors with a local presence, a project has a much higher level of accountability than a traditional government operated grant program. Not only must it obtain certification from the Department of Labor, but more important, it must earn the commitment of the

of the contributor. The local corporation - the financing source - will be there in the community with the ever present opportunity to evaluate the merits of its contribution.

THIRD, a tax credit system operates more quickly and more efficiently than the traditional grant making process. The proposed certification of the nonprofit training organization can be a simple step, and the use of the tax credit is a minor incremental addition to preparing the corporate return. The system avoids numerous planning exercises and reports which pertain to ancillary bureaucratic concerns rather than effective program operation. Moreover, money flows only within the confines of the local community, and costly funding delays can be avoided.

FOURTH, the program complements other training efforts (such as those sponsored by PICs), because of its inherent flexibiilty. Again, local initiative will enable the development of projects to fill gaps perceived among local training needs.

From a national perspective, a major objection to the program may be rooted in concern over the need for a balanced budget. A tax credit will reduce the revenue otherwise available to the federal treasury. Yet the likely amount of the reduction is not enough to be consequential particularly in light of enhancement effects brought about by enabling people to obtain jobs. Within a short period of time, trainees themselves will be paying taxes, and they are less likely to make burdensome demands on public service, (that is, for food stamps, medicaid, welfare, interest on unemployment borrowing, other transfer payments).

How much will the program cost? If, miraculously, 100 corporations each contributed an amount enabling them to make maximum use of the credit, (that is, $250,000), total revenue loss would be $25 million. (This amount might easily be made up by proposed improvements in tax collecting procedures.) Yet this would indicate an aggregate contribution level of $125 million, a sum that may exceed the reasonable capacities of nonprofit training organizations. At $5,000 per participant, a generous allowance, this would provide training for 25,000 people, a substantial achievement with a highly favorable cost-benefit ratio.

A second, and perhaps a more remote concern lies in the magnitude of the credit itself, that is, twenty percent. In certain states that have a NAP credit and a charitable deduction, (because of coupling with the federal system), the addition of the federal credit to an already available federal charitable deduction may create almost a cost free contribution.

Assuming a corporation with taxable income of $1 million, the normal tax owed to the federal government (absent state tax) would be $440,250, and the taxpayer would retain $559,750.

Assuming further a state tax of ten percent, the numbers would change as follows:

Income	$1,000,000
State tax	100,000
Federal taxable income	900,000
Federal tax	394,250
Combined tax paid	494,250
Taxpayer retains	505,750

Now, if we assume that the taxpayer makes a qualified contribution of $100,000 benefitting from both the proposed twenty percent credit and the federal charitable deduction, the numbers would look like this:

Income	$1,000,000
State tax (10%)	100,000
Federal gross	900,000
Minus contribution	100,000
Federal taxable income	800,000
Federal tax	348,250
Adjust for tax credit (20%)	328,250
Combined tax paid	428,250

Thus, by giving away $100,000, the combined tax burden is reduced from $494,250, a reduction of $66,000; the corporation in effect has given away only $34,000.

Now, in a state with a NAP credit of fifty percent, a $100,000 contribution has the following effect in light of the proposed credit:

Income	$1,000,000
State tax (10%)	100,000
NAP credit (added back)	50,000
Federal gross	950,000
Minus contribution	100,000
Federal taxable income	850,000
Federal tax	371,250
Adjust for credit(20%)	351,250
Combined tax paid	401,250

The combined tax burden is reduced from $494,250 to $401,250 or $93,000, and the corporation is only out of pocket in the amount of $7,000.

Finally, if we add in the use of a state deduction along with NAP, we get the following results:

Income	$1,000,000
Contribution	100,000
State tax (provisional)	90,000
NAP credit (added back)	50,000
Total state tax	40,000

Federal gross	960,000
Again, contribution	100,000
Federal taxable income	860,000
Federal tax	375,850
Adjust for credit (20%)	355,850
Combined tax paid	395,850

The tax burden has been reduced from $494,250 to $395,850 or $98,400; cost to the corporation is $1,600 for a $100,000 contribution.

S. 2224 can be a powerful incentive for private involvement in job training, and without belaboring the obvious, this is a vital need in our nation's economy.

MORGAN STANLEY

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INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

July 14, 1982

The Honorable Robert Dole
Chairman
Senate Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

We appreciate this opportunity to present our views on "The Corporate Takeover Tax Act of 1982" (S. 2687), introduced by Senator Danforth, and request that this letter be included as part of the record of the hearing to be conducted July 15, 1982, with respect to this bill.

We will limit our comments to two points regarding the proposed new section 338 of the Internal Revenue Code, providing for an election to treat certain stock purchases as asset acquisitions. First, we strongly urge lengthening the proposed 75-day period in which a corporation acquiring control of another corporation by purchase of stock must elect whether to treat the acquisition as a purchase of assets. Second, we urge reconsideration of the proposal requiring inclusion of all of an acquired corporation's affiliates in any election to treat the acquisition as an asset purchase.

A. The 75-day election period.

Existing Code section 334(b)(2), which this bill proposes to abolish, permits a corporation that acquires by purchase 80 percent of the stock of another corporation to allocate its cost basis in the stock to the assets of the acquired corporation, if the new subsidiary adopts a plan of liquidation within two years of the acquisition and the liquidation is completed within three years of adopting the plan. Proposed new section 338 substitutes a 75-day period to elect asset purchase treatment, but, if the election is made, the asset purchase is treated as occurring at the date the stock was acquired. No actual liquidation is required.

Since the section 338 election, if made, is retroactive to the date the stock was purchased, it appears to make no tax difference if the acquiring corporation has a period longer than 75 days to decide whether to make the election.

Morgan Stanley has assisted corporations in numerous mergers and acquisitions. We are intimately aware of the time and effort needed -- and indeed the surprises uncovered -- in analyzing the advisability of liquidating a newly purchased subsidiary under current law. Obviously, in many cases, it is not until after the acquisition that the acquiring corporation has access to the detailed information necessary to make such a decision. While tax attributes are often important in connection with an acquisition, they are often reviewed only in gross, and the detailed tax information necessary to make the decision required by section 338 would not even be available to the acquiror until after the acquisition. The eventual decision whether to treat the purchase as an asset acquisition requires lengthy independent valuations of real estate, operating assets, and intangibles such as goodwill and going concern value. For example, in the oil and gas industry, at least nine months is required for a Degoyer and McNaughton appraisal. In our view, it would be a very rare case to be able to make an informed decision on whether to make a section 338 election within 75 days.

The intent of the proposal, according to the Staff of the Joint Committee on Taxation, is to create more parity between a stock acquisition treated as an asset acquisition and a direct asset acquisition. In this regard, the Staff contrasts the one-year period under section 337 (i.e., a corporation that sells assets after adopting a plan of liquidation recognizes no gain or loss on the sale if the liquidation is completed within one year of adopting the plan) with the five-year period under current section 334(b)(2) (i.e., where a subsidiary's stock has been acquired by purchase, its assets will take on the cost basis of the stock if a plan of liquidation is adopted within two years and the subsidiary is liquidated within three years thereafter). Proposed section 338 provides that the acquired corporation, if the election is made, will be treated as having sold its assets on the acquisition date in a transaction to which section

337 applies, but goes on to provide only a 75-day election period, which hardly creates a parity with the one-year period in section 337. Furthermore, the section 337 election is made by a corporation disposing of its assets, thus having available not only the historical tax records but also the personnel intimately familiar with its tax situation. By contrast, the section 338 election must be made by an acquiring entity often without the same access to data and knowledgeable personnel.

We respectfully submit that the election period under section 338 -- the length of which has no tax consequences -- be extended to one year, in order to permit informed elections and to achieve parity with section 337.

B. The affiliated corporation rule.

This Committee should reconsider the provisions of section 338 that extend the consequences of the election to affiliates of the acquired corporation. The impetus for such a broad rule appears to be a concern that the acquiring corporation could otherwise selectively choose which acquired assets will acquire a cost basis, the same concern motivating the provisions of the bill dealing with partial liquidations.

There is considerable room for doubt as to whether there is any real abuse inherent in permitting an acquiring corporation to select a cost basis for certain assets and historic basis for other assets, so long as appropriate taxes are currently paid where there is a step-up in basis. In any event, the provisions of section 338 dealing with affiliates should be limited to preventing the use, by prearrangement, of multiple corporations to achieve selectivity. Where multiple corporations have been established *in the past* for bona fide business purposes, and there has been no manipulation to permit selectivity, there seems to be no justification for applying a blanket rule under section 338. The very broad reach of the affiliate provisions in the bill as drafted is likely to result in traps for the unwary, with many unintended consequences. We strongly recommend that the rules on affiliates be given much more careful study and tailored to reach only clear cases of perceived abuses.

Very truly yours,

MORGAN STANLEY & CO. INCORPORATED

By: Joseph G. Fogg III
Joseph G. Fogg III
Co-Director,
Mergers & Acquisitions
Department

Touche Ross & Co.

July 15, 1982

To Chairman Robert Dole and
Members of the Senate Finance Committee:

The corporate takeover tax provisions of the Senate Finance Committee bill - hearings on which have been announced for July 15 - would make some major changes in one of the most important and complex areas of corporate tax law. The changes, which could become effective less than four months after their original proposal by Congressman Stark, in HR 6295, would overturn certain key tax provisions which have been part of our judicial and statutory jurisprudence for almost 50 years.

On behalf of Touche Ross & Co., a major international public accounting firm with a tax practice covering the spectrum of business from the smallest to the largest, I would like to urge the Committee, and the full Senate, to consider extremely carefully the full ramifications of the proposed changes before they are enacted. With respect to this statement, Touche Ross is speaking only for itself; we are not representing any specific clients in the thoughts that follow.

It is important to understand that we are not suggesting the proposed changes are, per se, undesirable. In fact, I suspect that in the fullness of time, with a better opportunity to analyze the impact of the proposals, we would likely agree with many of them, conceptually if not necessarily with respect to all specific statutory detail. However, we have most serious reservations as to the nature of these most important and far reaching changes which appear, at least, to be headed down the road toward possible enactment with what can only be described as unwise and unnecessary haste.

We have set forth as an attachment to this letter some of the more technical points that concern us with respect to the proposals in the Danforth bill (S. 2687) and the Stark bill (HR 6295). The thrust of that discussion is to raise problems that are likely to occur should the provisions be enacted in the form approved by the Senate Finance Committee. On July 12, 1982, the House Ways and Means Subcommittee on Select Revenue Measures approved a bill substantially in accord with the Finance Committee approved provisions. Let me, therefore, briefly summarize, in less technical fashion, a few of our concerns.

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1900 M STREET N.W. - WASHINGTON, D.C. 20036 - (202) 452-1200

HR 6295 was introduced by Congressman Stark on May 6, 1982. On May 7 it was announced that hearings would be held with respect to that bill May 24. One day of hearings was, in fact, held on that date, just two and one half weeks after the bill's introduction. The bill would be effective September 1 of this year - less than four months after first introduced.

Correspondingly, Senator Danforth introduced his bill on June 29. No hearings were scheduled on either the Danforth or the Stark bill by the Finance Committee until after the Committee approved the provisions. The approved bill has an effective date of September 1, except for a limited grandfathering of tender offers outstanding or binding commitments entered into on or before July 1, 1982.

Both S. 2687 and HR 6295 would overturn the Supreme Court decision in *General Utilities and Operating Co*. vs. *Helvering*. That decision was handed down in 1935, 47 years ago. As Deputy Assistant Secretary Glickman testified to the Ways and Means Committee, it is codified, at present, in a number of sections of the 1954 Internal Revenue Code. Should *General Utilities* be overturned insofar as its theory is concerned? Maybe - there are undoubtedly cogent arguments on both sides of the issue. Should a 47-year old major tax concept be overturned after one day of hearings on each side of the Congress, and with less than four months for complete and rational consideration? Almost certainly not.

One of the perceived abuses most sought to be reversed by the proposed legislation is the ability of corporate affiliated groups to have the benefit of "selectivity" with respect to treatment of assets distributed in a partial liquidation - particularly as those rules integrate with the regulations for consolidated returns. As a result, for corporate shareholders, much of section 346 (dealing with partial liquidations) will be repealed under your bill. However, what seems not to have been properly recognized is that legislation is not even necessary to "solve" some of these problems; changing the consolidated return regulations to require immediate recapture of prior deductions and investment credit where assets are distributed within a consolidated return group via a partial liquidation, would close this perceived loophole without recourse to statutory changes.

In its attempt to achieve parity of treatment in all instances where taxable purchases versus tax-free reorganizations are used for the acquisition of assets or stock, it is proposed that the mandatory rules of section 334(b)(2) be repealed in favor of an elective provision (section 338) which would also change the substantive approach to such acquisitions. Section 334(b)(2) was codified in 1954, 28 years ago; this codification, in turn, was to bring certainty and objective standards to a judicial rule promulgated in 1951 by the 5th Circuit, in *Kimball-Diamond Milling Co.* vs. *Commissioner*. Have those rules served their purpose, and should they now be superseded by a different approach requiring complete parity of treatment? Again, perhaps. Is it appropriate to change what is undoubtedly one of the most important and settled tax concepts in the corporate acquisition area in the present less-than-four months context of getting a tax bill enacted? Again, almost certainly not.

One final illustration. Among the provisions of the present Code to be repealed is section 311(d)(2)(A). That section presently permits a corporation to use appreciated property in redemption of the interest of a more-than-10% shareholder who has owned his shares more than one year, without the corporation recognizing gain on the appreciation in that property. Yet, this has been one of the most common techniques, for family corporations, to retire the father-founder of the business and pass on management and control to the next generation. For a closely-held family business, where the father wishes to be bought out, and obtain a base for retirement capital, it is not uncommon that the only assets available to redeem him are represented by appreciated property. Under today's rules, the corporation can redeem the father using that property; the father pays a capital gain tax based upon the difference between the market value of that property and his presumably nominal cost in his stock, but the corporation does not have to pay tax on the property's appreciation when it distributes it in redemption.

The proposals you have before you would change that rule so that, at the time of redemption, first the corporation will pay tax (capital gain or ordinary, depending upon the nature of the asset) on the appreciation, and then the father will *still* pay the capital gain tax as under present law. Obviously, this is going to make providing for the business's founder substantially more difficult or costly, with what we believe will be far reaching consequences. Is that an appropriate step to take? Conceivably it is - one can certainly ask the question why that particular kind of redemption should excape tax at the corporate level - but we believe there are social policy arguments not being considered here that say parity in tax matters is not always the primary goal to be accomplished.

We are not prepared to state that these policy changes should not take place under any circumstances. We question, however, whether the policy consequences have been completely recognized where the debate has focused solely on the technicalities of tax parity and tax selectivity. And, we also question whether alternative approaches, such as consolidated return regulation amendments have been carefully enough thought through.

As one final common thread with respect to tax policy, we would call to your attention that each of the illustrations above confirms more strongly that a corporation is a separate entity for tax purposes, that we are moving more clearly toward imposing a second tax (via the corporation) in almost all instances, that any thrust toward backing away from the so-called double tax on income (once to the corporation, once to the shareholder) and integrating the two systems is severely damaged by the tax policy inherent in these bills.

In short, there are many, many issues we believe should still be addressed before final decisions are made. We urge that these provisions be withdrawn from the bill you are considering - not to be put on the shelf, but to be brought forth again next year at the beginning of a new Congress for a more reasoned and more fully developed debate.

We appreciate the opportunity to have you consider the above summary, and the technical statement which follows. We also ask that our full statement be included in the record of your hearings.

Sincerely,

Gerald W. Padwe

Gerald W. Padwe
Associate National Director -
Tax Services

:mpr
attachment

TECHNICAL DISCUSSION

There are a number of technical as well as practical difficulties that could result from enactment of the corporate takeover tax provisions of the Senate Finance Committee bill. Some of those problems are discussed below.

Two major perceived abuses are addressed by the proposed legislation: (1) the ability to obtain a step-up in basis of assets without current taxation of recapture income and without investment tax credit recapture; and (2) the avoidance of gain recognition to corporations on redemption transactions which are in substance sales of assets.

I. The Ability to Obtain a Step-Up in Basis of Assets Without Current Taxation of Recapture Income and Without Investment Tax Credit Recapture

Under present law, if a corporation seeks to acquire assets from a second corporation, a direct purchase of assets results in taxation to the second corporation of any gain realized on the sale. Alternatively, the acquiring corporation may purchase stock of the second corporation and then have the stock redeemed for the assets. If the redemption qualifies as a partial liquidation, resulting from a contraction of the business of the second corporation, the second corporation may have no taxable gain other than recapture of depreciation and other recapture items. If the acquiring corporation obtains 80% control of the acquired corporation, the corporations become eligible to file a consolidated return. Both section 336 of the Code and the consolidated return regulations make it possible to obtain a basis step-up for the distributed assets without current recognition of gain. Under the consolidated return regulations, recapture gains are deferred and recaptured gradually. In addition, there is no investment tax credit recapture when the property is transferred from one member of a consolidated return group to another.

In addressing the alleged abuse, the proposed legislation eliminates section 346(a)(2) and (b) from the Internal Revenue Code, with the exception of the application of section 346(b) as part of the redemption provisions to non-corporate shareholders who receive property from a trade or business conducted for at least five years by the distributing corporation. The repeal of section 346 of the Code does eliminate the perceived abuse. However, it also eliminates a substantial portion of the Internal Revenue Code and case law. The contraction of a business or the cessation or termination of one of two or more trades or businesses are concepts that have been ingrained in the tax law since the enactment of the 1954 code. The perceived abuse, that causes no current taxation of recapture income and no investment tax credit recapture, results, not from the partial liquidation provisions, but from the application of the consolidated return regulations to partial liquidations. It would appear that a simple change to the consolidated return regulations to disallow the postponement of recapture income and to require the triggering of investment tax credit recapture in transactions qualifying as partial liquidations would solve this perceived abuse.

II. The Avoidance of Gain Recognition to Corporations on Underlying Transactions Which Are in Substance Sales of Assets

Under present section 311(d), gain will generally be recognized to a corporation that redeems its stock with appreciated property, except in two situations which are particularly relevant in take-over transactions: (1) a distribution in complete redemption of a 10% or more shareholder who has held at least a 10% interest for more than 12 months (section 311(d)(2)(A)); and (2) a distribution of stock in a 50% or more owned subsidiary (311(d)(2)(B)).

The proposed legislation addresses transactions designed to avoid this aspect of gain recognition on what is, in substance, a sale of assets by eliminating the non-recognition provisions of sections 311(d)(2)(A) and (B). The courts, in the 311(d)(2)(A) area, have already recognized these redemption transactions as shams and have treated them as sales of assets. See: Edgar S. Idol (319 F.2d 647 (8th Cir. 1963), affirming 38 T.C. 444 (1962). Interestingly, the proposed legislation could be interpreted to deny the Internal Revenue Service the opportunity to litigate prior transactions employing 311(d)(2)(B) as a vehicle to avoid gain recognition on what is, in substance, a sale of assets. Alternatives to repealing section 311(d)(2)(A) and (B) include: (1) reliance on the courts and the ability of the Internal Revenue Service to litigate these issues; and (2) amending section 311(d)(2)(A) to substantially increase the holding period and to insert a similar holding period, under section 311(d)(2)(B). A corporation would not be willing to allow its funds to be subject to the market place and its flucuations while awaiting the opportunity to avoid the gain to the selling corporation on the distribution of its assets.

The problem inherent in the proposed legislation is a great burden on small corporations and individual shareholders. Under present law, a retiring founding shareholder can have his stock redeemed with appreciated assets (often the only corporate assets available for that purpose) without corporate tax liability. Under the proposed legislation, taxation at both the corporate and shareholder levels will be imposed. The double tax burdens may make it impossible for the founder to retire and leave a viable business for his children to operate.

In addition to the above recommendation to extend and add a holding period to both section 311(d)(2)(A) and (B), respectively, it is recommended that a provision be added to disallow the application of these provisions where tax avoidance is one of the principal purposes of the acquisition of the stock and subsequent redemption. It is further recommended with respect to this that if such a tax avoidance provision is established within the Code, that it be established with guidelines that will not pose the problems of definition that are found where that term is similarly used in sections 302(c)(2)(B) and 367 of the Code.

The proposed repeal of section 346 and section 311(d)(2) creates a difficult situation for the directors of a corporation that has been the target of a hostile takeover attempt. The repeal places the directors in the position of either allowing the takeover or of having to redeem the unfriendly party with appreciated assets and thus recognize income taxable to the target corporation. Neither of these alternatives may be considered protective of the interests of the other shareholders.

Another aspect of this perceived abuse involves transactions under section 332 and 334(b)(2) of the Code. In these transactions a corporation acquiring 80% or more of the stock of another corporation by purchase and adopting a plan of liquidation within two years from the purchase of the target corporation stock will obtain a basis for the assets of the target corporation equal to its basis in the purchased stock. Under present law the purchasing corporation in a consolidated return group can take advantage of target corporation net operating losses incurred during a possible five year interim period ending with the completion of the liquidation. In addition, recapture income recognized by the target corporation upon liquidation can be offset by losses of the purchasing corporation.

The proposed legislation would repeal section 334(b)(2) and add new section 338. Section 338 would provide the taxpayer an irrevocable election to treat the transaction as a section 337 sale of assets by the target corporation. The election would have to be made within 75 days after the purchase of 80% of the target corporation's stock. The practical difficulty inherent in this election is the 75-day period. In many instances, especially in hostile takeovers and tender offers, 75 days is insufficient time to allow the purchasing entity to make a proper determination of whether there should be a liquidation. Often, for non-tax reasons such as governmental regulations, it is impossible to determine within 75 days that a liquidation would be feasible.

One of the purposes of treating the old section 334(b)(2) liquidation as a section 337 liquidation is to avoid the possibility that recapture income will be offset against the losses of the purchasing parent corporation. However, this problem would not be eliminated by S. 2687 or HR 6295, since the liquidating corporation is a member of the consolidated return group at the time of liquidation and therefore the recapture income can be offset by the losses of the consolidated return group. A possible solution to this problem would be to add a provision to section 334(b)(2), to provide that the income on recapture should be treated as separate income and not as income includable in the consolidated return. If it is decided to enact section 338, a similar provision to that recommended above should be included to prevent this offset. Such a provision would indicate that, for purposes of recapture, the date of disposition of assets would be deemed to be the day preceding the purchase of the stock.

The preceding material is not intended to be a complete analysis of the many questions raised by the proposed legislation dealing with corporate takeovers and acquisitions. Rather it is meant to highlight the complexity and far reaching effects of these changes and point out some technical and practical problems involved. While we suggest some possible alternatives, we believe the problems would be better addressed by deferring further consideration of the provisions until 1983.

Statement of
BEATRICE FOODS CO.
before the
Senate Finance Committee
regarding
The Tax Treatment of Corporate Mergers & Acquisitions
July 15, 1982

Beatrice Foods Co. is one of the nation's leading diversified foods companies. From a single dairy operation founded in Beatrice, Nebraska in 1894, the company has grown to become one of the 50 largest U.S. corporations, with $9 billion in sales for fiscal 1982.

Worldwide, its 80,000 employees manufacture and distribute 9,000 products through 400 profit centers in 90 countries. Its food-related businesses accounted for 77 percent of total sales in fiscal 1982. As is the case with many successful diversified corporations, Beatrice has always made a concerted effort to achieve the most efficient use of corporate assets.

On January 13, 1982, Beatrice purchased all of the stock of several subsidiaries of Northwest Industries, Inc. for $580 million. Nearly all of the acquired entities were engaged in the sale and distribution of various beverages, e.g., soft drinks, bottled water, and alcoholic beverages. Despite this common theme, the individual companies vary widely in their asset composition, product mix, mode of operation, relative use of labor and capital; financial structure, and in their contractual, and state and federal governmental restrictions. Governmental licenses are involved as are critical franchise relationships.

During the course of the negotiations for the acquisition, Beatrice undertook to structure the transaction to permit sufficient time to consider these complexities prior to the time when a decision on partial or complete liquidations would have to be made. Moreover, it was always understood by Beatrice that such factors as legal, financial, tax, personnel, and general business considerations might require a retention of the corporate existence of some of the acquired entities.

Beatrice believed that the complexity of the businesses acquired was such that a full two years would be necessary to complete a well-reasoned analysis of the most beneficial corporate form for each acquired entity. Under then current law, Beatrice was entitled to that two-year period to make its evaluations as to the continued existence or liquidation, complete or partial, of each such entity.

Since the enactment of the Internal Revenue Code of 1954, an acquiring company has been permitted a two-year period from the date of purchase of the stock of an acquired subsidiary within which to adopt a plan of complete liquidation to qualify for the tax treatment provided by Section 334(b)(2). Although no comparable time requirement exists with respect to partial liquidations, Beatrice had always planned that the results of its studies and appraisals would be carried out and completed within the two-year period following the acquisition of the subsidiaries. This would allow a decision as to whether each acquired subsidiary should be completely liquidated, partially liquidated, or continued in corporate solution.

The statutory provisions upon which the acquisitions in question were based and which would be substantially modified or repealed by the Finance Committee's action have continued in their basic substantive form since the enactment of the 1954 Code and represent a codification of legal doctrines which have been in effect for almost a half century. Furthermore, in this instance, the long-standing tax treatment provided by the Treasury regulations with respect to partial liquidations of members of an affiliated group filing a consolidated return was relied on by Beatrice when making its January 13 acquisition -- a date which preceded the introduction of the original House bill by Congressman Stark by almost four months. Beatrice was also aware of the many favorable private letter rulings recently issued by the Internal Revenue Service when it considered the possibility of undertaking partial liquidations in the future.

The provision contained in the Senate Finance Committee's bill with respect to binding contracts entered into on or before July 1, 1982 would not appear to be applicable to Beatrice's January 13 acquisition. Therefore, Beatrice would have to complete its liquidation by August 31. If forced to meet that date, the resulting distribution would likely be disruptive to operations, require substantial redeployment of personnel, and would have to be accomplished without adequate professional appraisal and other necessary studies and analyses. Substantial errors might be made, needless costs would be incurred and there would always be a lurking uncertainty as to whether the most appropriate course of action was followed.

It is respectfully submitted that both equity and sound tax administration demand that a more appropriate transitional rule be provided with respect to the repeal of Section 346 of the Code, particularly in a situation containing the many problems presented in a multi-company acquisition. Such a rule might require that a plan of liquidation be adopted no later than two years from the date of acquisition and that distributions in liquidation thereunder be completed no later than July 1, 1984.

Since the time the Finance Committee reported out its bill on July 2, there has been a great deal of discussion about transition rules. Some people have expressed the concern that a transition rule permitting partial liquidations for acquisitions entered into prior to July 1 would allow any company that made an acquisition at any time in the past to carry out a future partial liquidation. The two-year limitation suggested above addresses this concern. Others have expressed the concern that a transition rule not result in additional revenue loss to the Treasury. We suggest that the revenue impact of our suggested rule should not be materially different from what the Committee has proposed since those companies involved in structurally simple acquisitions will be able to complete their partial liquidations in either event.

A rule which would require that the plan of liquidation be adopted within two years of the date of acquisition and that the distribution be completed by July 1, 1984, would permit companies who relied on prior law to complete their transactions in an orderly fashion but would preclude the use of these same rules by those whose acquisitions were not made in reliance on such rules. We respectfully submit that our proposed transitional rule achieves equity, prserves a sound tax administrative goal of certainty and causes little, or no, loss of revenue.

MEMORANDUM REGARDING PROPOSED CHANGES IN THE TAX TREATMENT OF CORPORATE MERGERS AND ACQUISITIONS
(S. 2547 and S. 2687)

July 16, 1982

S. 2547 and S. 2687 would each add a new provision to section 302 of the Code to treat corporate stock redemptions consisting of the assets of a trade or business, or attributable to the corporation's ceasing to conduct a trade or business, as distributions not essentially equivalent to dividends. (Section 3 of S. 2547 and section 101(c) of S. 2687.) The provision set forth in S. 2687, which would become new section 302(e) of the Code, is adopted by section 226(c) of the Committee's amendment to H.R. 4961.

Another provision in S. 2687 (section 201) would replace section 334(b)(2) of the Code with a new section 338 that would provide an election to treat certain stock purchases as asset purchases. This provision is incorporated in section 229 of the Committee's amendment to H.R. 4961.

The following comments suggest certain technical improvements in proposed sections 302(e) and 338.

Proposed Section 302(e)

1. The Trade or Business Requirements

The "trade or business" requirements of proposed section 302(e) would incorporate the present requirements of section 346(b) relating to partial liquidations. Substantially identical "trade or business" standards are also set forth in section 355(b) relating to corporate "spinoffs" and other distributions of stock in controlled subsidiaries.

The Internal Revenue Service's rulings position under section 355(b) reflects case law*/ that has delineated the scope of activities qualifying as "trades or busineses." (Rev. Rul. 75-160, 1975-1 C.B. 112.) Because of the wide scope of the "contraction" principle of section 346(a)(2), which, by enabling a great many corporate distributions to qualify as partial liquidations, the Service generally has not had to reach section 346(b) in its partial liquidation rulings and accordingly has issued comparatively few rulings under section 346(b).

To provide greater certainty as to the intended scope of section 302(e), we think it would be worthwhile for the Committee to express its intention that the "trade or business" requirements of that section be applied in accordance with established law under section 355(b). This point probably could be covered most effectively in the legislative history.

2. Eligible Shareholders

In limiting its reach solely to redemptions from non-corporate shareholders, new section 302(e) would follow the corresponding provisions of S. 2687 and H.R. 6725 ("Stark

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*/ Rafferty v. Commissioner, 452 F.2d 767 (1st Cir. 1971); United States v. Marett, 325 F.2d 28 (5th Cir. 1963); Commissioner v. Coady, 289 F.2d 490 (6th Cir. 1961), aff'g 33 T.C. 771 (1960).

II"). By contrast, S. 2547 and H.R. 6295 ("Stark I") would make their new section 302 provisions applicable to redemptions from any shareholder. We believe this aspect of proposed section 302(e) is unduly narrow and that the approach taken by S. 2547 and Stark I, with a slight modification, would represent the sounder tax policy.

The Committee's report on H.R. 4961 implies that section 302(e) was restricted to redemptions from noncorporate shareholders because of a perceived policy justification for preserving capital gain treatment when a legitimate business desire to operate one of a corporation's trades or businesses in proprietorship or partnership form is the reason for the redemption. But corporate shareholders, too, frequently have legitimate business reasons for wishing to transfer a subsidiary's trade or business to a higher-tier corporate shareholder. Such transfers are common, for example, to locate similar operating units dispersed among several members of a corporate group within a single corporate entity. Such internal relocations of businesses can yield significant operating economies and can achieve clearer and more direct systems of managerial responsibility. At times, such transfers can also improve the borrowing capacity of either or both of the distributing corporation or its corporate shareholder.

Except in one instance, which we will address momentarily, we see no sound policy reason supporting a distinction between corporate and noncorporate shareholders under section 302(e). The problem of undue selectivity among the assets of a corporation for which a basis step-up would be obtained under section 302(e), which is one of the chief concerns at which the repeal of section 346 is directed, will be properly controlled by the "trade or business" requirements -- the same for corporate and noncorporate shareholders alike. The possibility of the distributing corporation's escaping the recognition of gain on the unrealized appreciation in the distributed assets as the price of obtaining the basis step-up for the shareholder, which has existed until now by virtue of the application of section 336 to partial liquidations, will generally be eliminated as well under the expanded scope of section 311(d). Since section 302(e) would apply even to pro rata redemptions, there is no basis for distinguishing between corporate and noncorporate shareholders on dividend-equivalence grounds. Finally, the applicability of section 355 to corporate and noncorporate shareholders alike when a corporation distributes a "trade or business" in corporate form supports similar comparability of treatment when the assets of a "trade or business" are distributed in kind.

The only situation in which the application of section 302(e) to redemptions from corporate shareholders might perpetuate conceptually unsound tax policy would be when a distributing corporation and its corporate shareholder join in the filing of consolidated returns. The provisions of section 1.1502-14(c)(1) of the consolidated return regulations would defer the recognition of gain by the distributing corporation that all of the bills under consideration intend to tax immediately as the price of obtaining basis step-ups. Even if the Committee is not persuaded that modification of consolidated return principles is a sufficient response to the various tax planning techniques now possible under the broad scope of the partial liquidation rules, we believe that limited reform in the consolidated return area is certainly preferable to wholesale denial of section 302(e) to corporate shareholders. If the Committee is unwilling for this purpose to rely exclusively on administrative action to modify the consolidated return regulations appropriately, an equally effective alternative would simply be to make section 302(e) inapplicable solely to redemptions in which the corporation and its corporate shareholder join in the filing of consolidated returns.

If nothing else, we urge the Committee to give special attention to redemptions by foreign corporations. Foreign corporations generally are ineligible to participate in consolidated returns. Moreover, if redemptions by foreign corporations are treated as dividends because of the inapplicability of section 302(e) to corporate shareholders, domestic corporate shareholders would be subject to taxation on the full fair market value of such distributions and generally would not be able to obtain dividends-paid deductions with respect to such distributions. Dividends received by corporate shareholders of domestic corporations, by contrast, are taxable only to the extent of the adjusted basis of the distributed assets and generally are substantially offset by dividends-received deductions. Finally, the need to realign the operations of affiliated corporations to achieve operating economies and managerial efficiency, as described above, can be more acute in a foreign context because of the greater significance that some foreign countries accord to legal entity structures.

For these reasons, if the Committee will not make section 302(e) applicable generally to redemptions from corporate shareholders, we urge it at least to make the provision applicable to redemptions from corporate shareholders of foreign corporations.

3. Actual vs. Constructive Redemptions

Under present law, there generally must be an actual redemption of stock in order for section 302 to apply. For purposes of section 346, an actual stock redemption is not necessary; rather, a constructive stock redemption is deemed to occur if section 346 otherwise applies.*/ The section 346 rule clearly would be the appropriate rule under section

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*/ See Fowler Hosiery v. Commissioner, 301 F.2d 394 (7th Cir. 1962); Rev. Rul. 81-3, 1981-1 C.B. 125; Rev. Rul. 79-257, 1979-2 C.B. 136.

302(e). We suggest that this be made clear either by an amendment to the proposed statute or by a clarification of the legislative history.

4. Effective Date

The Committee's amendment to H.R. 4961 would leave the current partial liquidation rules in place for distributions by a corporation whose shares were acquired pursuant to a tender offer outstanding on July 1, 1982 or under a binding contract entered into on or before July 1, 1982, if the plan of liquidation is adopted on or before October 1, 1982.

The purpose of requiring the existence of a tender offer or binding contract as of July 1 appears to be to demonstrate a commitment to complete an acquisition. In some cases, a party may have embarked on a serial acquisition of a target's stock as of July 1, effectively committing it from a business standpoint to complete the acquisition, although there may be no formal tender offer or binding contract outstanding. To cover these cases, we suggest that the effective date provision be supplemented to grandfather acquisitions pursuant to a plan of acquisition begun on or before July 1, 1982. The scope of this amendment could be reasonably restricted by requiring at least 20 percent of the target's stock to have been acquired by July 1.

In addition, many taxpayers in the process of completing transactions that have a legitimate claim to grandfathering protection will be unable to close such transactions and adopt plans of liquidation before October 1. If the Committee wants to grandfather all transactions planned in justifiable reliance on existing law, as we believe it should, the July 1 date should be the only relevant date, and there should be no further requirement that a plan of liquidation be adopted by any fixed date. If the Committee feels that there must be some cut-off date for adoption of the plan of liquidation, taxpayers should be given at least until January 1, 1983 for the grandfathering mechanism to be reasonably fair and equitable.

Proposed Section 338

The relationship between subsections (g)(3) and (g)(7) of proposed section 338 may benefit from clarification. The purpose of subsection (g)(7) is to prevent circumvention of section 338 by dividing an acquisition of shares in a target corporation (or its subsidiaries) among different members of an affiliated group. However, if, for example, the parent of an affiliated group ("P") arranges for one of its subsidiaries ("S") to purchase all of the stock in a target ("T") and P itself directly acquires the stock of one of T's subsidiaries ("T-Sub") and then transfers that stock to any other subsidiary of P under section 351, subsection (g)(3) might be construed to deny "purchase" treatment with respect to T-Sub. This result would allow S to make a section 338 election for T without a corresponding election being required for T-Sub.

The present language of section 338 probably should be construed to preclude this possibility, but a clarification in the legislative history might be helpful. It should be made clear that subsection (g)(7) is intended to overrule categorically the rule in In re Chrome Plate, Inc., 614 F.2d 990 (5th Cir. 1980), which held that a purchase of target stock by a parent followed by the parent's transfer of such stock to its subsidiary under section 351 was not a "purchase" with respect to the subsidiary for the purpose of section 334(b)(2).

LEE, TOOMEY & KENT

SENATE FINANCE COMMITTEE

Hearing re Proposed Reforms on the Tax Treatment of
Corporate Mergers and Acquisitions
July 15, 1982
(S.2687)

I am William J. Caveney, a member of the New York Bar and a CPA admitted to practice in New York. I am employed, with the title of Tax Counsel, by the Warner-Lambert Company, a multinational company based in New Jersey, with annual sales exceeding $3.5 billion. As several members of this Committee are aware, I am Chairman of the International Taxation Committee of the Tax Executives Institute, Inc., but I am not testifying on behalf of TEI or any other organization on this topic.

My testimony is in response to the concern expressed by Senator Byrd at the July 1 hearing as to whether the business and financial aspects of this proposed legislation on acquisitions had been fully studied, and to Chairman Dole's later request for assurance that the proposed legislation "does not go further than necessary to address the abuses it intends to stop." I have advised scores of sellers and buyers on the financial reporting and tax aspects of the many alternative methods of structuring any deal, and my principal concern is that the pre-tax economics should not be distorted by hastily enacted or overly-broad tax legislation.

I. Redemption of Stock by using Stock of a Majority-owned Subsidiary

This proposed provision is a true case of going after a non-issue with a shotgun, or: "don't tax you, don't tax me, tax the fellow without any income". In spite of the prior characterizations that this Committee has heard about the celebrated deals where no corporate tax was paid when a valuable subsidiary was removed from corporate ownership -- it is absolutely clear that ESMARK had no economic income when it divested its energy subsidiary.

I have described this type of transaction to senior corporate financial officers as the "ultimate sacrifice in favor of shareholders" --the corporation receives absolutely nothing, and the shareholders directly derive the entire economic benefit of the divestiture.

The ESMARK shareholders who actually sold their stock to MOBIL for cash clearly had a taxable transaction, and the remaining ESMARK shareholders only had a bigger percentage of a smaller pie. The only conceivable gain to ESMARK itself was that it only had one-half as many shareholders, and therefore a smaller dividend to pay out of its reduced assets.

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How could you explain to a corporate executive that if he enters into such a deal he will: (1) reduce the corporate net worth, (2) show no reportable pre-tax income -- and now (3) have to pay a tax on the corporation's right to reduce its net worth? That's right -- the proposed law would impose a tax on non-income! I can perceive no policy grounds to support such a novel and perverse result.

Since such a transaction is presently non-taxable at the corporate level, regulations might be appropriate to specifically provide that the corporation would not be permitted any tax deduction for any related expenses.

Along with the proposed repeal of Code Section 311(d)(2)(B) that was just discussed, the legislation would also eliminate, with its broad brush, Section 311(d)(2)(A), a provision of keen interest to closely-held small businesses. This exception to having a second taxable gain at the corporate level is only available where the redemption is of all of the stock of a 10% or greater shareholder, and where that shareholder has had such a substantial direct investment for at least a year.

We should again focus on the fact that this is not presently a tax-free transaction -- it is taxable to the redeeming shareholder. The proposed legislation would add a second level of tax on the corporation itself. I again submit that there are no policy grounds that call out for a new double-tax in our system.

It is not conceivable that there could be a true tax revenue increment if this legislation is enacted, particularly since the first part would serve rather as an economic injunction against using a subsidiary as a means of completing a redemption. A public corporation would be forced to sell the subsidiary directly, pay the tax and distribute the thus reduced proceeds to the shareholders.

II. Proposed Repeal of Code Section 334(b)(2) - Acquisition followed by Liquidation

1) There should be no abuse potential where the step-up benefits are only available on a "complete liquidation" (after a "partial liquidation" within a consolidated tax return is eliminated by another part of the proposed legislation as discussed below).

2) The recapture taxes should be at the buyer's level, payable with the buyer's return. If put in the "final tax return" of seller, there will be uncalled for penalties because of a natural failure to pay estimated taxes on recapture.

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3) A forced election within 75 days after an acquisition is not enough time to make an informed decision on whether an acquisition should be treated as a purchase of assets. This will simply create a new trap for the ill-advised. There is no need at all for a new separate election, since it could be filed with the buyer's tax return in year of acquisition.

4) Grandfathering - The present language appears to cover only two-thirds of the proper group to be grandfathered, that is binding contracts and "tender offers" (the latter often connotes an unfriendly acquisition). The transitional rules should also cover friendly acquisitions where (1) there was a pre-July 1, 1982 signed "letter of intent" providing most of the significant terms, including total consideration to be paid, or (2) either the buyer or the entity to be acquired had begun a solicitation of the target company's shareholders prior to July 1, 1982. The present Section 334(b)(2) mechanism should be held available for any transaction meeting these rather stringent guidelines.

5) Congress should repeal the 1976 law change that treats the buyer of a foreign subsidiary in a Section 334(b)(2) transaction as if he had sold the subsidiary.

Section 1248 was initially designed to cover situations of a terminated ownership interest -- not where a new owner buys a corporation which happens to have one or more foreign subsidiaries that the acquirer plans to retain permanently. And yet, Sections 1248(e) and (f) now act to treat the buyer as if he were instead a seller.

III. Partial Liquidation

In my opinion, this portion of the proposed law is a rather complete case of overkill. I personally agree that corporations should not be permitted to selectively treat a transaction as if they had only acquired certain assets of a target company (as opposed to all of the assets) -- however, the perceived abuse is caused by an unnecessary and questionable portion of the Treasury Department's consolidated tax return regulations. (Treasury Regulations §1.1502-14(c)(1), which provides a deferral of the recapture income). Why should any asset-strip transaction within a consolidated tax return (other than a complete liquidation covered by Section 334(b)(2)) be treated as anything other than as a dividend with a carryover tax basis? Within the context of the consolidated tax return regulations, with its otherwide well-integrated basis and dividend rules, I can see no logic for the aberration that treats a partial liquidation in a completely different fashion.

I submit that the entire abuse situation that is the

cont'd. .....

target of this portion of the proposed legislation can be corrected by simply directing the Treasury to treat any partial liquidations while in consolidation as intercompany dividends under Treasury Regulations §1.1502-14(a). There is no reason to in any other way throw out years of law and practice. The sweeping legislation creates unnecessary turmoil -- not simplicity -- with little change in the revenue impact from the solution proposed in this paragraph.

In the meantime, the IRS could simply be instructed by Congress to issue no more rulings on this type of a partial liquidation.

The basic premise is quite simple -- while in consolidation there is no policy reason to differentiate between (1) contributing a division to a subsidiary and (2) taking a division away from a subsidiary.

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